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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1991

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ECONOMICS

JANUARY 24, 1990—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

JANUARY 31, 1990—VIEWS OF THE OFFICE OF MANAGEMENT AND BUDGET

FEBRUARY 1, 1990—VIEWS OF THE SECRETARY OF THE TREASURY AND COUNCIL OF ECONOMIC ADVISERS

Volume I of III

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VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

WEDNESDAY, JANUARY 24, 1990

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:12 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Hollings, Riegle, Lautenberg, Simon, Sanford, Wirth, Robb, Domenici, Grassley, Nickles, and Gramm.

Staff present: John L. Hilley, staff director; and Alan Cohen, assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; and Cheri Reidy, economist and senior analyst.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman Sasser. The committee will come to order.

I want to welcome our colleagues here this morning to the first hearing of 1990 of the Senate Budget Committee, and on behalf of the committee, I wish to welcome the distinguished head of the Congressional Budget Office, Dr. Robert Reischauer, this morning. And I want to thank you for joining us this morning, Dr. Reischauer.

In recent years, it's been the duty of the Congressional Budget Office to serve as the bearer of unpleasant tidings—in this case, I suspect, the unpleasant truth.

Dr. Reischauer, it's fortunate for you it's no longer the custom to shoot the messenger who brings the bad news. I'm unhappy to say, however, that these days in Washington it seems that it's become the custom to ignore the message that's brought by the Congressional Budget Office and others.

I think this represents a very dangerous tendency.

Today, we'll hear from Dr. Reischauer and the Congressional Budget Office that the true deficit for fiscal year 1990 will be somewhere in the neighborhood of $138 billion, and perhaps even more when all of the numbers are in.

That's going to be $38 billion over our targets for Gramm-Rudman-Hollings for this fiscal year. And just for the sake of comparison, the Gramm-Rudman-Hollings target for fiscal year 1989 was $136 billion, and the actual deficit for that year was $152 billion.

So we missed the target by some $16 billion in 1989, and in 1990 we're going to miss the target, it appears, by some $38 billion, which amounts, in essence, to simply deleting 1 year from the whole Gramm-Rudman-Hollings schedule.

So for fiscal year 1991, we face once again a $138 billion deficit, according to the Congressional Budget Office, and our target is $64 billion. So what we have, in essence, is a $75 billion hole to fill, using CBO numbers.

If we continue on the course we seem to have established, we can expect to miss the 1991 target by a margin even more substantial than the one we're missing our 1990 target by.

In short, I think we can clearly see that the trend is in the wrong direction.

No one, and certainly not those of us who went through the agonizing process of getting a budget passed last year—and I'm sure the distinguished ranking member, Senator Domenici, will remember those long hours and the long nights and lost weekends—can take any solace from the numbers that we're seeing and are about to hear here this morning.

But we can, I believe, draw from these numbers some conclusions that may make subsequent budgets more honest and more balanced, and perhaps even more responsible.

First, I think it's become obvious to all dispassionate, unbiased observers that the Office of Management and Budget consistently and substantially understates the deficits. They do this by resorting to the most optimistic economic assumptions that can be credibly employed, and sometimes even economic assumptions that are, indeed, incredible themselves on their face. Last year in the administration's budget submission, OMB predicted that interest rates on 90-day Treasury bills would drop to 5.9 percent by January 1990. As of January 22, they were actually at 7.2 percent. And let's bear in mind that for every percentage point of interest increase, that represents about $10 billion as far as the deficit is concerned.

Now, the second clear conclusion from the numbers I cited earlier is that we simply are not winning the battle against the deficit. CBO is estimating that even with the growing social security surplus, counted in the budget, these annual deficits will remain between $130 billion and $141 billion through 1994. By fiscal year 1995, our national debt will stand at a mind-boggling $4.5 trillion if current practices persist.

Well, this leads me to my final conclusion, I tell my colleagues. We simply cannot proceed down this dead-end street of increasing this deficit by these large amounts every year. To put the issue bluntly, it appears to me that Gramm-Rudman-Hollings has really not, in the final analysis, assisted us in reducing the deficit. I suspect that one of the authors of that legislation sitting to my left might agree with me on that statement.

I think what it has done is helped keep in place a set of fiscal policies that are patently inadequate to this country's needs, and those include a bloated defense budget, distorted and inequitable tax policies, and off-budget liabilities that we pass on to our children.

We are locked into a regressive set of fiscal policies that I might say have been strikingly exposed by Senator Moynihan's call for a reduction in the social security payroll tax. Before we proceed to a more complete discussion of all these issues, I'd conclude by illustrating why Senator Moynihan and Senator Hollings and Senator Sanford and others are so frustrated. Let me just do this with one final set of, I think, very illuminating numbers.

According to the Congressional Budget Office, the social security surplus will grow from $66 billion in 1990 to some $128 billion in 1995. By that final year, 1995, the surplus on a yearly basis in the Social Security Trust Fund will mask over one-half of the operating deficit of the U.S. Government.

If we rip away that veil, the on-budget deficit will grow from $204 billion in the operating budget in 1990 to a staggering $246 billion deficit in the operating budget of the U.S. Government in 1995.

Well, with those words of encouragement this morning, I turn to my friend and the distinguished ranking member of this committee, Senator Domenici, for any comments he might wish to make. Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator **Domenici**. Well, I don't know if I can add much to that message we just heard, Mr. Chairman. Gloom is the order of the day.

Let me suggest, however, I wish there was another way to control our appetite to spend without having to have a Gramm-Rudman-Hollings target with a guillotine waiting if we don't do our job. But, frankly, I don't agree with you that the process hasn't worked. I think in the context of fiscal policy you've got to talk about current projections relative to something that would have otherwise occurred. I very seriously doubt whether we would have done as well without Gramm-Rudman turned loose up here on our own. In fact, I don't think the defense budget would have been any lower. You suggest it's bloated. I don't think tax policy would have been any different. You suggest it's inequitable. And, frankly, I would only add one more observation. If we missed the target last year, you suggest we missed it by $16 billion.

I want to tell the members where $13 billion of the difference came from. We repealed catastrophic health insurance in the middle of the fiscal policy stream. That accounts for about $5 billion. We had FSLIC spending, instead of occurring in 1 year, occurring in another, and that was another $8 billion. That's $13 billion.

I make no apologies for missing the target. In fact, I think we're really making a mistake, Mr. Chairman, by filling that $10 billion float we've got in the policy process. The $10 billion leeway was put in the law precisely because things like catastrophic repeal happen.

Let me say to the new Director of the CBO, you were a long time coming, that wasn't your fault. We're delighted to have you on board, and I join the chairman in welcoming you here. For many, your numbers represent the starting point in this budget battle, and I understand your annual report is not going to be made available until January 31. Is that correct?

Dr. **Reischauer**. Correct.

Senator **Domenici**. We do have some preliminary numbers, and I assume you're going to talk about them today. Is that what the chairman was referring to?

Dr. **Reischauer**. Yes.

Senator **Domenici**. We look forward to having you around for a long time.

I think "the more things change, the more they stay the same" is relevant. In the past few years, things have changed considerably around here.

Incidentally, I used to be chairman. I'm not chairman any more. That's a change. [Laughter.]

Senator **Hollings**. I love the change.

Chairman **Sasser**. Sometimes I wish you still were chairman, Senator Domenici. [Laughter.]

Senator **Domenici**. Listen, Senator Hollings, you were chairman once, and I became chairman. And I was delighted to have you as my ranking member.

Senator **Hollings**. Everybody was chairman.

Senator **Domenici**. In any event, I'll do my job.

The membership of this committee—indeed, all committees—has changed. We have a new Cabinet and new leadership in the Senate and House. But following all this change, I'd like to make just a few observations about things that haven't changed. Interestingly enough, Federal spending in 1980 was 22.1 percent of our then gross national product. Interestingly enough, CBO's preliminary numbers show that baseline Federal spending in 1990, 10 years later, is 22.1 percent of GNP.

Granted, instead of arguing how much to increase the defense budget as we did in 1980, the recent events in Eastern Europe and the Soviet Union will turn the debate perhaps 180 degrees the other way. Now, the argument will be how much to cut the defense budget. It still comes to recommending what we consider to be appropriate policy objectives.

Defense and international spending were competing with domestic spending in 1980. They continue to do that. Entitlements and mandatory spending will still compete with discretionary spending, and issues important to Western States will still be pitted against issues important to Eastern States.

Then on the other side of the ledger, the revenue side, let's not forget that Federal revenues represented 19.4 percent of the GNP in 1980. Isn't it interesting in 1990 CBO's preliminary figures show baseline revenues are still at about 19.6 percent of GNP? So instead of debating the structure of the income tax system as we did in 1980, I guess we're going to focus on social security taxes. So I think the discussion is still going to come down to the appropriate level of taxation, no matter which tax you're talking about.

This decade began with the deficit at 2.8 percent of GNP. As the decade ends, I understand your preliminary numbers will show the baseline deficit is about 2.5 percent of GNP for 1990. Certainly, the Federal deficit increased markedly over this period of time, and clearly it's debatable whether this Congress and any President could have controlled it more than we did. Perhaps we could have.

Today, we have a specific deficit target to shoot for, and that was not true in 1980. But the larger goal has not changed. We all want lower deficits. We want lower deficits so that we can improve the national savings rate. We want lower deficits so interest rates will come down. We want lower deficits so that we can improve our competitiveness in the world markets and not be so dependent for our well-being on foreign countries.

Our fiscal problems are clear, but they are not easily solved. They are, nonetheless, easier to solve than they would have been had the pattern in the late 1970's and early 1980's of inflation and recession and high interest rates persisted throughout this decade.

We're going to get the administration's budget on Monday, I assume, and I just want to allude to whose economic assumptions are right. Let me just give you two scenarios. The committee decided to use the administration's economic assumptions when we produced the 1989 budget. At that time, CBO projected 2.1 percent real growth; the administration projected 2.9 percent growth. We used them, and we were criticized as wildly optimistic. When the year finished and we got the actual figures, both were underestimates. Real growth was 4.4 percent. I'm not saying we have been right on this committee nor that OMB directors have been right. But neither do I think the CBO has been right nor the Blue Chip or anyone else. They've all been right sometimes and wrong sometimes.

We used the administration's assumptions again last year, and we were criticized again. The administration's assumptions called for 3.3 percent growth in 1989; CBO had 2.9 percent. We won't get the final numbers until later on, but likely the actual growth will fall somewhere in between.

I was recently asked: How can you fight the same fight year after year? Well, this will be my 15th year on this committee, and I keep reminding myself of what Herb Stein said, "budgeting is governing." Yes, we'll fight some of the same fights. But there are new circumstances and new accomplishments to be made.

I'm ready. We're going to have differences of opinion, and some will be on political lines, Mr. Chairman. But I do hope we are able to get a budget so that we will have a guidepost for the remainder of this year and into the next decade.

Thank you very much.

Chairman **Sasser**. Thank you very much, Senator Domenici.

In view of the fact that we have nine members here today and ready, we'll hold questions to initially 5 minutes. That will take us about 45 minutes to get the first round done, Senator Hollings. Then we can go longer after the first round.

Dr. Reischauer, it's my understanding that OMB will come in with a Gramm-Rudman-Hollings baseline deficit—excuse me. We're skipping your testimony, Dr. Reischauer. [Laughter.]

I have already read it, but go ahead. Forgive the lapse.

STATEMENT OF DR. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. **Reischauer**. Mr. Chairman and members of the committee, it's a pleasure to be here. For a minute, I thought maybe you really did not want to hear the bad news. After you assured me that the messenger wouldn't be shot, I relaxed and decided to assure you that I wouldn't disappoint you, and that I would deliver a painful message.

I thought I'd focus my remarks here this morning on four of the issues that are covered in my prepared statement.[1] The first two are the CBO economic forecast and our updated budget projections. The third and the fourth topics are issues that have generated a considerable amount of discussion over the past few months; namely, the magnitude of a possible peace dividend and the budgetary treatment of the Social Security System.

With respect to the economic outlook, CBO's new forecast is close to that of the consensus of private forecasters. We expect real GNP to grow by about 1.8 percent in 1990. This is only a bit below our estimate of 2 percent for the growth rate for 1989, if one strips out the effects of the rebound from the 1988 drought. In 1991, we expect real growth to perk up a bit to a rate of about 2.5 percent. In part, the 1991 pickup in the growth rate will be the result of lower interest rates that we expect to occur during 1990. Average T-bill rates in 1990 should fall a bit over one point below what the average was during 1989, and longer term rates should fall by about half that amount.

Short-term interest rates are projected to rise in 1991 in the CBO forecast because we believe that the Federal Reserve will be moving at that point to head off any inflationary pressures that might be developing.

The CBO forecast envisions very little change in inflation. The Consumer Price Index rose by 4.6 percent in 1989, which, by the way, was the most rapid increase since 1981, and we expect it to rise by about 4.1 percent in 1990 and then 4.4 percent in 1991.

Let me turn now to our budget outlook. CBO expects the budget deficit for the current fiscal year, 1990, to come in at around $138 billion. Our baseline projections suggest that the deficit will remain stuck in this range, somewhere between $135 billion and $141 billion through 1993, before it falls to about $130 billion in 1994 and $118 billion in 1995.

CBO's $138 billion estimate for the 1991 deficit is some $74 billion above the target of $64 billion, which is laid out for fiscal year 1991 in the Balanced Budget Act. If this excess of $74 billion were to be eliminated through sequestration using CBO's estimates, it would require across-the-board cuts of 19 percent in defense and 28 percent in the nondefense programs.

Let me say a few words about why the budget outlook for 1991 has improved so little since our August forecast. It has only improved by $6 billion. The basic explanation for this is that the budget-related legislation that was enacted between August and November of last year reduced the 1991 deficit by only $5 billion, which is considerably less than the $12 billion impact that it had on fiscal year 1990. There are two reasons why the deficit reduction impact of this legislation fell between 1990 and 1991. The first of these is that the reconciliation bill contained $6.5 billion of nonrecurring savings in 1990; $3.5 billion of this came from accounting changes and timing shifts, such as taking the post office off-budget;

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[1] See prepared statement on p. 9.

and another $3 billion came from speeding up payroll tax collections and certain other excise tax collections.

The second reason why the amount of deficit reduction fell between 1990 and 1991 is that the appropriations bills that were passed last fall decreased defense spending authority by less than they increased nondefense spending authority, thereby raising outlays in 1991. This increase was masked because in 1990 we allowed $2 billion worth of added receipts from prepayments of foreign military sales. This reduces outlays, but it does so only temporarily; namely, only in fiscal year 1990.

Many people wonder why it is so hard to reduce the deficit when baseline revenues grow by substantial amounts from year to year. For example, our projections for the difference between 1990 and 1991 suggest that baseline revenues are going to grow by $70 billion. Why isn't it easy to reduce the deficit when revenues are going up by this amount?

The answer, of course, lies in the fact that, under current law, outlays also rise automatically. On page 14 of my statement, there is an analysis of this growth. It shows that $59 billion—or 84 percent of the $70 billion growth in baseline outlays that CBO expects—will be attributable to built-in factors, such as cost-of-living increases and growth in the caseloads in programs such as social security. Moreover, to those increases, add increases in the price of medical care and the increased use of expensive medical technologies in medicare and medicaid.

It is interesting to note that just three programs—social security, medicare, and net interest—account for over half of the baseline spending growth in the CBO projections. Only $11 billion of the increase that is expected between 1990 and 1991 stems from discretionary increases in appropriations that are assumed in the CBO baseline.

Over the past several weeks, there has been a good deal of discussion about the possibility that a relaxation in East-West tensions might allow the United States to reduce its defense budget. The exact size and shape of any such policy changes, of course, are yet to be defined. Nevertheless, CBO has calculated two illustrative defense paths for discussion purposes. These calculations provide a rough indicator of the savings that are possible relative to the CBO baseline, which, as you all know, assumes that defense appropriations are adjusted each year to reflect inflation fully.

The first of these paths, which can be found on page 18 of my prepared statement, allows real defense budget authority to decline by 2 percent a year, or by approximately the rate that we have experienced over the past 3 years. Under this scenario, defense outlays fall by $4 billion below the baseline in 1991 and by some $30 billion below the baseline by 1995.

The second path calls for annual real declines of 4 percent, which would roughly correspond to a freeze of nominal defense budget authority. Under this scenario, we would see defense spending reduced by $8 billion in 1991 and by some $57 billion by 1995. To the extent that these savings were translated into lower deficits, net interest costs would also be reduced for the Federal Government.

But even if all of the savings in the larger of the two examples that I have just laid out were devoted to cutting the deficit, the savings estimated for 1993 would amount to only a quarter of what would be needed to reach the Gramm-Rudman-Hollings targets for that year, which, of course, is a balanced budget.

In recent months, a good deal of attention has also been focused on the surpluses that are building in the Social Security Trust Funds and how these surpluses should be treated when we establish our national deficit targets. The Balanced Budget Act currently includes social security in its calculations and makes social security subject to the same fiscal discipline as the rest of the budget. From an economic perspective, this is the correct approach. The purpose of reducing the deficit is to increase national saving, which can spur capital formation and economic growth.

The Federal budget deficit absorbs private saving, thereby impairing the growth of living standards. The annual balance in the social security programs affects national saving in exactly the same way as the balance in any other government account. Thus, the most appropriate measure of the impact of the Federal budget on the economy is the total deficit, not any single part of it. The total Government deficit, including social security and all of the other trust funds, determines the Government's fiscal stance, its drain on private credit markets, and the amount of saving that it diverts from uses that can promote growth in living standards.

Let me conclude by making a few observations about the accuracy of budget estimates over the past decade. Fiscal year 1989 marked the tenth straight year that the actual deficit has exceeded the deficit specified in the budget resolution. The fiscal year 1989 deficit of $152 billion was only $17 billion over the level specified by the budget resolution. I say "only" because the average error for the decade has been some $40 billion.

For the decade as a whole, the use of optimistic economic assumptions, has accounted for $17 billion, or 43 percent of the $40 billion average error in the budget resolution's deficit estimates.

CBO believes that the new economic assumptions and the baseline projections that we are releasing today represent a prudent basis for making budget plans for fiscal year 1991 and beyond. Using more optimistic assumptions will increase the risk that, again, the Congress will fail to achieve the budgetary targets that it has laid out for itself.

Thank you.

Chairman SASSER. Well, thank you very much, Dr. Reischauer.

[The prepared statement of Dr. Reischauer follows:]

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on the Budget
United States Senate

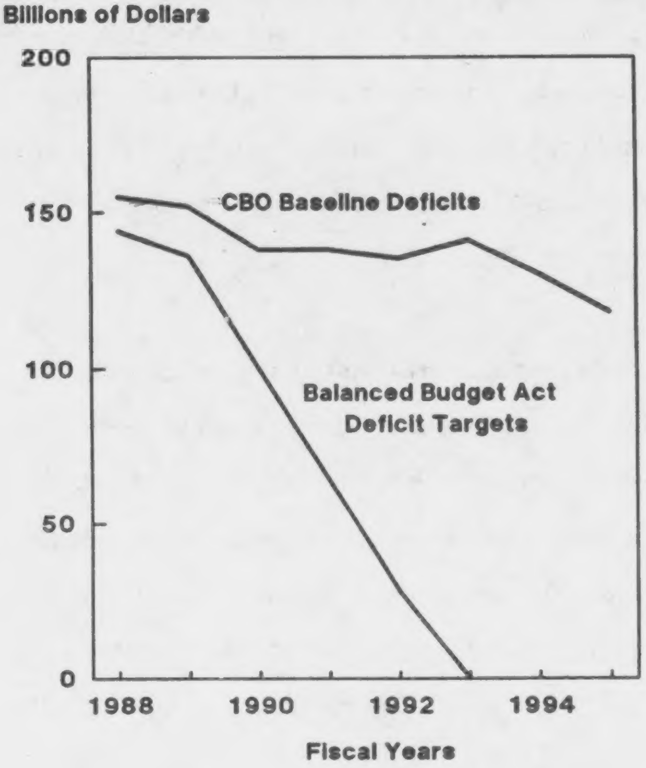
January 24, 1990

Mr. Chairman, I am pleased to appear before the Committee this morning to discuss the latest economic and budget projections of the Congressional Budget Office (CBO). These projections will be described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1991-1995,* which will be released on Wednesday, January 31.

CBO forecasts that the U.S. economy will grow by almost 2 percent in 1990 and slightly faster next year. The restrictive monetary policy that was in force from 1987 through mid-1989 is still tending to slow the economy, as will the tighter fiscal policy slated for 1990. The Federal Reserve began to loosen monetary policy in June 1989, and CBO expects that it will continue to encourage lower interest rates for most of this year. CBO forecasts that this policy will succeed in avoiding a recession in 1990 without boosting inflation.

CBO estimates that the federal budget deficit will fall from $152 billion in fiscal year 1989 to $138 billion in 1990. Over the next few years, no further progress in reducing the deficit can be expected under current budgetary policies. The Balanced Budget Act requires a deficit of $64 billion in 1991 and a balanced budget in 1993. But without spending cuts or tax increases, the deficit in 1993 is likely to be no lower than in 1990. Figure 1 compares CBO's baseline budget projections for 1990 through 1995 with the statutory targets.

Figure 1. Baseline Deficits and Targets



SOURCE: Congressional Budget Office.

CBO expects that the Federal Reserve will safely steer the economy between the shoals of a recession and higher inflation by further reducing interest rates this year. Most private-sector forecasters share this view, and the CBO forecast is close to the consensus for 1990 and 1991, as shown in Table 1.

CBO forecasts that real gross national product will grow 1.8 percent on a fourth-quarter-to-fourth-quarter basis in 1990. This is near the 1989 rate of 2.0 percent, when real GNP is adjusted to exclude the rebound of the farm sector from the previous year's drought. Lower interest rates in 1990 are expected to contribute to slightly faster growth of 2.5 percent in 1991. Short-term interest rates are projected to rise in 1991 as the Federal Reserve moves to head off inflationary pressures.

The economic forecast assumes further movement toward the Balanced Budget Act target in 1991. Together with declines in long-term interest rates, this shift will reduce the fraction of the economy's real output devoted to personal and government consumption and increase the share going to business and residential investment. Continued depreciation of the dollar will increase real net

TABLE 1. COMPARISON OF CBO AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Actual	Estimated	Forecast	
	1988	1989	1990	1991
Fourth Quarter to Fourth Quarter (Percentage change)				
Real Gross National Product				
CBO	3.4	2.5	1.8	2.5
Blue Chip	3.4	2.5	1.8	2.4
Implicit GNP Deflator				
CBO	4.0	3.9	4.1	4.0
Blue Chip	4.0	3.9	4.0	4.0
Consumer Price Index (CPI-U)[a]				
CBO	4.3	4.6	4.1	4.4
Blue Chip	4.3	4.6	4.2	4.2
Calendar-Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	5.5	5.3	5.6	5.5
Blue Chip	5.5	5.3	5.6	5.6
Three-Month Treasury Bill Rate				
CBO	6.7	8.1	6.9	7.2
Blue Chip	6.7	8.1	7.1	7.2
Ten-Year Government Note Rate				
CBO	8.8	8.5	7.8	7.7
Blue Chip	8.8	8.5	7.7	7.7

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1989); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

NOTE: The CBO forecast does not reflect preliminary 1989 fourth-quarter data for GNP published in January 1990.

a. CPI-U is the consumer price index for all urban consumers.

b. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year government notes.

exports. The increases in investment and net exports mirror a slightly higher national saving rate, which comprises saving by both the private sector and government. Nonetheless, the national saving rate next year will remain well below historical levels.

Low saving slows the growth in living standards by reducing the accumulation of productive capital by Americans. The low rate of saving is particularly disturbing because the retirement of the post-World War II baby-boom generation will also cause living standards to grow less rapidly starting in about 2010. A smaller portion of the population will be working then, and what those workers produce will have to be shared--through Social Security and other means--with the relatively large number of retired people. Taking steps to increase the size of the economy in the next century would help ease the period of transition.

The CBO forecast envisions little change in inflation. Continued high rates of employment and factory utilization and rising import prices, which tend to increase inflation, will be balanced by slower growth in labor costs stemming from higher productivity growth. The consumer price index is expected to rise 4.1 percent in 1990 and 4.4 percent in 1991, only slightly below the 1989 rate of 4.6 percent. The implicit GNP deflator is projected to rise 4.1 percent in 1990 and 4.0 percent in 1991, about the same as in the past two years.

For 1992 through 1995, CBO's economic assumptions are not a forecast of future economic conditions but are projections based on historical trends. Real GNP is projected to grow at an average annual rate of 2.4 percent, in line with labor force and productivity growth. Inflation and unemployment both hold steady. Interest rates are projected to decline throughout the 1992-1995 period until they reach the historical average of inflation-adjusted rates. CBO's five-year economic assumptions are shown in Table 2.

The short-run forecast and long-run assumptions do not reflect the goal of some policymakers to reduce the inflation rate to a negligible amount over the next five years. CBO's analysis suggests that inflation will not come down without a sharp or a prolonged increase in unemployment. Cutting the deficit, however, might reduce inflation in the longer term by increasing national saving, investment, and productivity growth.

THE BUDGET OUTLOOK

The budget baseline shows what would happen if current budgetary policies were continued without change. It is not a forecast of future budget outcomes, since many policy changes will doubtless be made

TABLE 2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1992 THROUGH 1995

	Estimated	Forecast		Projected			
	1989	1990	1991	1992	1993	1994	1995
Nominal GNP (Billions of dollars)	5,235	5,534	5,893	6,279	6,688	7,121	7,579
Nominal GNP (Percentage change)	7.3	5.7	6.5	6.5	6.5	6.5	6.4
Real GNP (Percentage change)	2.9	1.7	2.4	2.5	2.5	2.4	2.4
Implicit GNP Deflator (Percentage change)	4.2	4.0	4.0	4.0	4.0	4.0	4.0
Fixed-Weighted GNP Price Index (Percentage change)	4.6	4.1	4.3	4.3	4.3	4.3	4.3
CPI-U (Percentage change)	4.8	4.0	4.3	4.3	4.3	4.3	4.3
Unemployment Rate (Percent)	5.3	5.6	5.5	5.5	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)	8.1	6.9	7.2	6.9	6.5	6.1	5.8
Ten-Year Government Note Rate (Percent)	8.5	7.8	7.7	7.6	7.5	7.4	7.3
Tax Bases (Percentage of GNP)							
Corporate profits	5.7	5.6	5.7	5.7	5.6	5.7	5.6
Other taxable income	21.6	21.3	21.1	21.1	20.9	20.7	20.5
Wage and salary disbursements	50.2	50.5	50.5	50.5	50.5	50.5	50.6
Total	77.6	77.4	77.3	77.2	77.1	77.0	76.8

SOURCE: Congressional Budget Office.

NOTE: CPI-U is the consumer price index for all urban consumers.

over the next five years. The baseline methodology hews to the rules contained in the Balanced Budget Act. For revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense and nondefense discretionary spending, the projections for 1991 through 1995 are based on the 1990 appropriations, increased only to keep pace with inflation.

Baseline Projections Through 1995

Under CBO's baseline budget projections, the deficit is projected to remain near its 1990 level of $138 billion in 1991 through 1993. The baseline deficit then falls to $130 billion in 1994 and $118 billion in 1995, as shown in Table 3.

The Balanced Budget Act calls for a deficit of $64 billion in 1991, $28 billion in 1992, and zero in 1993. CBO's 1991 projection of $138 billion exceeds the target by $74 billion. Unless other spending cuts or tax increases were enacted, the act would require eliminating the excess deficit through automatic across-the-board cuts of 19 percent in defense and 28 percent in nondefense programs. Under the terms of the Balanced Budget Act, however, the Office of Management and Budget, not CBO, determines whether automatic spending cuts are necessary and how large the cuts must be.

TABLE 3. BASELINE BUDGET PROJECTIONS

	1989	1990	1991	1992	1993	1994	1995
				In Billions of Dollars			
Revenues	991	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,143	1,205	1,275	1,339	1,418	1,464	1,555
Deficit	152	138	138	135	141	130	118
Deficit Targets[b]	136	100	64	28	0	b	b
				As a Percentage of Gross National Product			
Revenues	19.2	19.6	19.6	19.5	19.4	19.3	19.3
Outlays	22.2	22.1	22.0	21.7	21.5	21.2	20.8
Deficit	2.9	2.5	2.4	2.2	2.1	1.8	1.6

SOURCE: Congressional Budget Office.

a. The budget figures include Social Security, which is off-budget but is counted for purposes of the Balanced Budget Act targets. For comparability with the targets, the projections exclude the Postal Service, which is also off-budget.

b. The Balanced Budget Act established targets for 1988 through 1993.

The budget outlook is not as gloomy if the deficit is compared with the size of the economy. As a share of gross national product (GNP), the baseline deficit falls from 2.5 percent in 1990 to 2.4 percent in 1991 and 1.6 percent in 1995. The assumption of no real growth in discretionary spending causes outlays to fall from 22.1 percent of GNP in 1990 to 20.8 percent of GNP in 1995. Revenues also decline slightly, however, from 19.6 percent of GNP in 1990 to 19.3 percent in 1995. Although personal income taxes keep pace with the growth in the economy, all other tax sources remain stable or decline relative to GNP.

Social Security Projections

The Balanced Budget Act currently includes Social Security in its calculations and makes Social Security subject to the same fiscal discipline as the rest of the budget. From an economic perspective, this approach makes sense. The purpose of reducing the deficit is to increase national saving, which can spur economic growth and capital formation. The federal budget deficit absorbs private saving, thereby impairing the growth of living standards. The annual balance in the Social Security programs affects national saving in exactly the same way as the balance in any other government account.

Thus, the most appropriate measure of the impact of the federal budget on the economy is the total deficit, not any part of it. The total government deficit, including the Social Security and other trust funds, determines the government's fiscal stance, its drain on credit markets, and the amount of saving that it diverts from uses that promote growth in living standards.

Nevertheless, the Balanced Budget Act requires that the Social Security trust funds be shown as off-budget to highlight their contribution to the totals. With income of the trust funds exceeding benefits and other costs, the Social Security surplus grows from $66 billion in 1990 to $128 billion in 1995, as shown in Table 4. An increasing amount of this surplus, however, reflects interest payments received from the Treasury. Because these interest payments are merely intragovernmental transfers, they do not reduce the government's need to borrow in the market. Excluding interest, Social Security's contribution to holding down the total deficit looks much smaller--about $50 billion in 1990 and $78 billion in 1995.

TABLE 4. ON- AND OFF-BUDGET TOTALS
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
On-Budget (Excludes Social Security and Postal Service)						
Revenues	779	828	874	924	978	1,037
Outlays	984	1,041	1,095	1,163	1,220	1,283
Deficit	204	212	221	239	242	246
Off-Budget (Social Security)[a]						
Revenues	288	309	330	352	376	401
Outlays	222	234	244	254	264	273
Surplus	66	74	85	98	112	128
Total[a]						
Revenues	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,205	1,275	1,339	1,418	1,484	1,555
Deficit	138	138	135	141	130	118

SOURCE: Congressional Budget Office.

[a] For comparability with the Balanced Budget Act targets, the projections exclude the Postal Service, which is also off-budget.

Sources of Growth in Spending

Baseline revenues and outlays are both projected to grow by $70 billion in 1991. Table 5 shows that $59 billion of the growth in outlays occurs automatically under current law. These built-in increases stem from such factors as cost-of-living increases and growth of caseloads for Social Security and other retirement and disability programs. Spending for Medicare and Medicaid, two of the fastest growing programs, is driven up by increases in the price of medical care and by the wider use of more expensive medical technologies. Net interest outlays--arguably the least controllable component of spending--are determined by the government's deficit and by interest rates.

Figure 2 illustrates how just three programs contribute half of the growth in spending. Social Security and Medicare account for $29 billion, or over 40 percent of the growth in 1991. Another $6 billion--almost 10 percent of the growth--is added by net interest. Other increases required under current law total $24 billion. Only $11 billion of the projected increase in spending in 1991 stems from discretionary increases in appropriations that are assumed in the CBO baseline.

TABLE 5. COMPONENTS OF CBO BASELINE SPENDING PROJECTIONS (By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995
1990 Level	1,205	1,205	1,205	1,205	1,205
Current Law Increases					
COLAs for entitlement programs[a]	10	25	41	57	74
Increases in price of medical care[a]	4	9	16	24	32
Increases in entitlement program caseloads	7	14	22	30	40
Increases in use of medical care[b]	11	23	36	48	61
Rising benefits for new Social Security beneficiaries[b]	6	10	13	16	20
Expected changes in offsetting receipts	c	-3	-6	-9	-12
Increased interest costs	6	12	20	25	29
Other	14	15	22	16	13
Subtotal	59	105	164	209	257
Inflation Adjustments to Maintain Real Spending for Discretionary Programs					
Defense purchases	3	9	16	24	32
Defense pay	3	8	12	17	22
Nondefense purchases	3	8	15	22	29
Nondefense pay	1	3	5	7	9
Subtotal	11	28	48	70	93
Total Increases	70	134	212	279	350
CBO Baseline	1,275	1,339	1,418	1,484	1,555

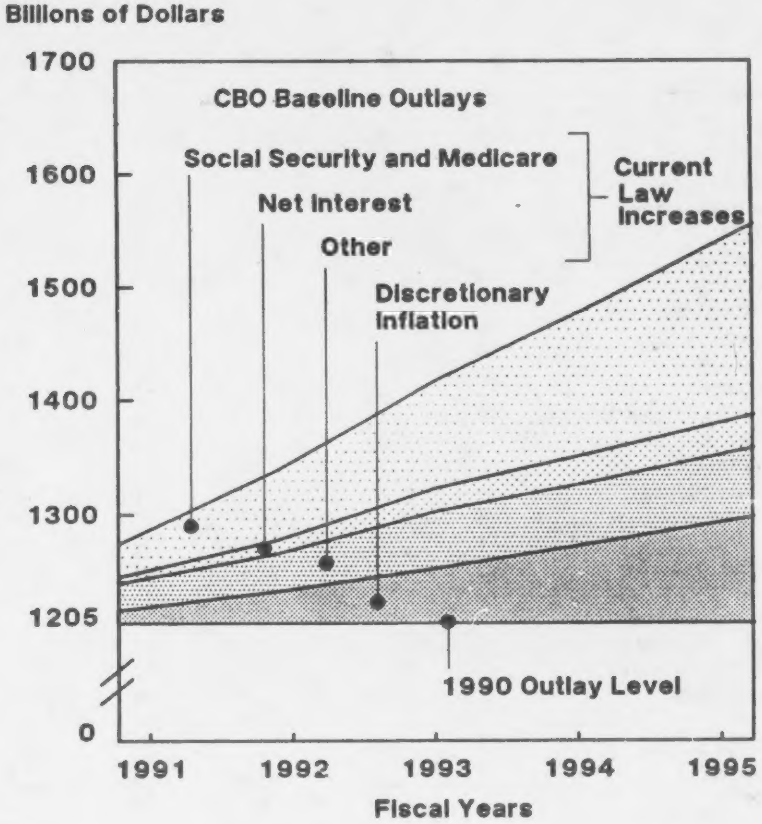
SOURCE: Congressional Budget Office.

a. Represents program growth that could be eliminated by freezing cost-of-living adjustments and certain medical reimbursement rates.

b. All growth not explained by increases in caseloads and prices.

c. Less than $500 million.

Figure 2. Sources of Growth in Outlays



SOURCE: Congressional Budget Office.

Alternative Spending Paths

As noted earlier, the baseline projections for discretionary spending simply adjust the 1990 appropriations to allow for inflation. As a result, the baseline makes no explicit allowance for activities not covered in the 1990 appropriations, such as renewing long-term subsidized housing contracts that are about to expire. Conversely, the baseline for 1991 through 1995 includes money for items that were funded in 1990 but may not be needed in the future, such as the decennial census and hurricane and earthquake relief. Adjusting the baseline for these special situations, however, would have little effect on the totals.

Of greater consequence are the assumptions about defense spending. The CBO baseline assumes that defense appropriations are adjusted fully for inflation, the same treatment that applies to nondefense discretionary spending. Nevertheless, real defense appropriations have been falling since 1985. Many observers assume that future appropriations will likewise fail to match inflation. In their view, large federal deficits will join with reduced East-West tensions to restrain the defense budget.

Table 6 shows two hypothetical paths for defense spending relative to the CBO baseline. The first involves annual real declines in defense budget authority at roughly the rate of the last three years. A 2 percent annual real decline in defense budget authority would generate up to $4 billion in defense outlay savings next year, growing to about $30 billion in 1995, compared with the CBO baseline. Annual real declines of 4 percent double the savings and roughly correspond to a five-year freeze in nominal defense budget authority. This second path would reduce federal spending by $33 billion in 1993 and $68 billion in 1995, including reductions in interest costs. Even if all these savings were devoted to cutting the deficit, however, they would be only a quarter of what is needed to balance the budget in 1993.

Changes in the Projections Since August

CBO's new baseline projections reflect all legislation enacted during the first session of the 101st Congress and are based on up-to-date economic and technical estimating assumptions. The new projections differ little from those published in CBO's August 1989 report (see Table 7). Recently enacted legislation has reduced the projected deficits, but in most years these legislative changes are largely offset by economic and technical revisions.

TABLE 6. HYPOTHETICAL SAVINGS FROM ALTERNATIVE DEFENSE BUDGET PATHS COMPARED WITH THE CBO BASELINE
(By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995
2 Percent Annual Real Decline in Budget Authority					
Change in Defense Spending	-4	-9	-15	-22	-30
Change in Interest Spending	a	-1	-2	-3	-5
Total Change in Deficit	-4	-10	-17	-25	-35
4 Percent Annual Real Decline in Budget Authority					
Change in Defense Spending	-8	-18	-30	-43	-57
Change in Interest Spending	a	-1	-3	-6	-10
Total Change in Deficit	-8	-19	-33	-50	-68

SOURCE: Congressional Budget Office.

a. Less than $500 million.

TABLE 7. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994
August 1989 Baseline Deficit[a]	141	144	141	143	128
Changes					
Enacted legislation					
Appropriations	-1	4	6	6	6
Reconciliation					
Sequestration	-3	-4	-4	-4	-4
Other	-11	-5	-7	-7	-8
Repeal of catastrophic health insurance	5	1	-2	-2	-2
Other legislation	-1	-1	-1	-1	-1
Debt service	b	-1	-1	-2	-3
Subtotal	-12	-5	-8	-9	-12
Updated economic assumptions					
Revenues[c]	2	-1	b	6	13
Outlays	-3	-8	-10	-14	-19
Subtotal	-1	-9	-10	-8	-6
Technical reestimates					
Revenues[c]	1	b	1	4	4
Farm price supports	-2	b	1	1	1
Deposit insurance	8	2	2	-2	-3
Medicaid and Medicare	1	2	4	5	7
Social Security	1	1	2	2	2
Net interest	2	1	1	3	4
Other outlays	b	1	2	2	4
Subtotal	11	8	13	16	20
Total changes	-3	-6	-5	-2	2
January 1990 Baseline Deficit[d]	138	138	135	141	130

SOURCE: Congressional Budget Office.

a. Includes Social Security.

b. Less than $500 million.

c. Revenue decreases are shown with a positive sign because they increase the deficit.

d. Includes Social Security and excludes the Postal Service.

Before adjourning in November, the Congress cleared all 13 regular appropriation bills, adopted a reconciliation bill, and repealed catastrophic health insurance under Medicare. In total, this legislation cut the deficit by an estimated $12 billion in 1990 but by only $5 billion in 1991. The savings shrink in 1991 for two reasons. First, the reconciliation bill contained $7 billion in nonrecurring savings in 1990--$4 billion from accounting changes and timing shifts, such as taking the Postal Service off-budget, and another $3 billion from speeding up payroll and certain excise tax collections. Second, the appropriation bills reduced outlays temporarily in 1990 because of $2 billion in receipts from foreign military sales prepayments, which will not be repeated in later years. The appropriation bills actually increased nondefense spending authority and raised outlays in 1991 and later years.

CBO's updated economic assumptions reduce the deficit by $1 billion in 1990, $9 billion in 1991, and similar amounts thereafter. By itself, lower projected inflation reduces baseline outlays and revenues in tandem and has little effect on the deficit. But the robust performance of financial markets increases receipts from taxes on capital gains, which reduce the overall loss in revenues.

All other revisions, termed technical reestimates, boost the deficit by $11 billion in 1990, $8 billion in 1991, and $20 billion in 1994. The

1990 increase is dominated by higher deposit insurance outlays, which result from additional spending for troubled banks, the outlay of money appropriated for savings and loans in 1989 but not spent, and a reduction in receipts from borrowing by the off-budget Financing Corporation. In later years, the technical reestimates arise from various sources. Notably, higher Medicaid outlays add to the deficit by increasing amounts, as spending continues to outstrip previous projections. Projected spending is also higher for Social Security and other benefits, revenues are slightly lower, and debt service costs therefore rise.

BUDGET ESTIMATES DURING THE 1980s

The start of the 1990s provides a good opportunity to review the accuracy of budget estimates over the past decade. Again this year, as it has for the past 10 years, CBO has analyzed the most recent Congressional budget resolution estimates to see to see how and why they differed from the actual outcome.

The Congressional budget resolution for fiscal year 1989, adopted in June 1988, called for a deficit of $135.3 billion, slightly below the Balanced Budget Act target of $136 billion. When fiscal year 1989 ended last September 30, however, the red ink totaled $152.1

billion--$16.8 billion over the budget resolution. The 1989 error was less than the average error for the decade, which was $40.2 billion. Nonetheless, 1989 marked the tenth straight year that the actual deficit exceeded the budget resolution.

Table 8 divides the differences between the actual outcomes and the budget resolution estimates of revenues, outlays, and the deficit into those resulting from policy, economic, and technical assumptions. Use of optimistic economic assumptions accounts for $17.2 billion, or 43 percent, of the average error in budget resolution estimates during the 1980s. The remaining difference between the budget resolution estimate and the actual outcomes stems equally from policy actions that did not conform to those assumed and from errors in technical estimating assumptions. Fiscal Year 1989 marks the first time that the economic assumptions used for the budget resolution were not too optimistic. The technical differences, however, were above average.

CBO believes that its current economic assumptions and baseline budget projections represent a prudent basis for making budget plans for 1991 and the following years. Using more optimistic assumptions will increase the risk that, once again, the Congress will fail to achieve the budgetary targets that it has set for itself.

TABLE 8. SOURCES OF DIFFERENCES BETWEEN ACTUAL BUDGET TOTALS AND FIRST BUDGET RESOLUTION ESTIMATES FOR FISCAL YEARS 1980-1989 (In billions of dollars)

	Assumptions			
Fiscal Year	Policy	Economic	Technical	Total
Revenues				
1980	6.2	8.4	-3.5	11.1
1981	-3.7	5.0	-12.6	-11.2
1982	13.0	-51.9	-1.1	-40.0
1983	-4.6	-58.0	-2.7	-65.3
1984	-13.7	4.5	-3.9	-13.1
1985	-0.2	-20.0	3.3	-16.8
1986	-1.5	-23.0	-2.1	-26.6
1987	22.1	-27.0	6.7	1.7
1988	-10.9	3.6	-16.5	-23.8
1989	0.7	33.5	-7.8	26.4
Average Difference	0.7	-12.5	-4.0	-15.8
Average Absolute Difference	7.6	23.5	6.0	23.6
Outlays				
1980	19.6	12.4	15.6	47.6
1981	24.5	6.4	16.0	46.9
1982	1.2	24.1	7.7	32.9
1983	17.6	0.5	8.1	26.2
1984	1.5	7.1	-18.0	-9.4
1985	22.8	-5.2	-12.9	4.8
1986	14.2	-12.1	20.1	22.2
1987	6.8	-11.9	13.0	7.9
1988	-2.0	11.7	12.0	21.7
1989	17.5	13.9	11.8	43.2
Average Difference	12.4	4.7	6.4	24.4
Average Absolute Difference	12.8	10.5	13.5	26.3
Deficit				
1980	13.4	4.0	19.1	36.6
1981	28.2	1.4	28.6	58.1
1982	-11.8	76.0	8.8	73.0
1983	22.2	58.5	10.8	91.5
1984	15.2	2.7	-14.1	3.7
1985	23.0	14.8	-16.2	21.6
1986	15.7	10.9	22.2	48.8
1987	-15.3	15.1	6.3	6.2
1988	8.9	8.1	28.5	45.5
1989	16.8	-19.7	19.6	16.8
Average Difference	11.6	17.2	11.4	40.2
Average Absolute Difference	17.0	21.1	17.4	40.2

SOURCE: Congressional Budget Office.

NOTE: Differences are actual outcomes less budget resolution assumptions.

Chairman **Sasser**. What does CBO project as its Gramm-Rudman baseline deficit for fiscal year 1990?

Dr. **Reischauer**. For 1990, we project $138 billion.

Chairman **Sasser**. All right.

Dr. **Reischauer**. For 1991, we project the same level.

Chairman **Sasser**. How much deficit reduction is going to be needed, then, to reach the deficit reduction target of $64 billion using CBO's estimate?

Dr. **Reischauer**. $74 billion.

Chairman **Sasser**. $74 billion. Now, OMB, from what we can understand, is projecting a baseline deficit of about $100 billion, which is about a $38 billion difference between CBO and OMB. Do you have any feel for what the major reasons are which account for the big difference in these two estimates?

Dr. **Reischauer**. No; I haven't seen the detail of the administration's budget proposal, which will not be released, of course, for another 5 or 6 days. But from the reports in the press, I assume that a large portion of the difference, if not all of it, comes from the more optimistic economic assumptions that the administration will be using.

Chairman **Sasser**. Right. Well, if history is any guide to what's going to happen in a few days, that's certainly correct.

Now, by 1993, Gramm-Rudman-Hollings hopefully was going to have the deficit down to zero or have a balanced budget. What does CBO predict now for 1993?

Dr. **Reischauer**. For 1993, our new numbers would suggest a deficit of $141 billion.

Chairman **Sasser**. Of $141 billion. What is the general pattern for the size of your projections for deficits for the outyears? Are they going up or going down?

Dr. **Reischauer**. They are hanging pretty much the same for the next 4 years. In 1990 through 1993, we have deficits that range from $135 billion to $141 billion without any particular pattern of decline or increase, and then beyond 1993 we have the deficit falling to $130 billion in 1994 and $118 billion in 1995.

Chairman **Sasser**. Well, what is the pattern of the deficit in the outyears between now and 1994 when you remove the social security surplus?

Dr. **Reischauer**. If the social security surplus were out of the calculations, we would have a deficit in the balance of the Federal activity that would start, I think, with $204 billion in 1990 and rise gradually to $246 billion by 1995.

Chairman **Sasser**. What did you say——

Dr. **Reischauer**. I might point out that we have an increase of roughly $42 billion over this period, and a large amount of it—as a matter of fact, $36 billion—is accounted for by the growth in the interest payments being made from the Treasury to the Social Security Trust Fund. So, in a sense, it is an example of the Government taking money out of one of its pockets and putting it in its other pocket.

Chairman **Sasser**. Just as a matter of curiosity, Dr. Reischauer, how much money does the Government presently owe the Social Security Trust Fund? Do you happen to have those figures close at hand, or could you give us a ball park estimate?

Dr. **Reischauer**. The figure is about $163 billion, and as you mentioned in your opening remarks, the surplus in the Social Security System will be rising at $66 billion this year, $74 billion next year, up to $128 billion by 1995. These amounts, then, are added to those trust fund reserves.

Chairman **Sasser**. These are year-to-year surpluses.

Dr. **Reischauer**. These are year-to-year surpluses that you add to the $160-odd billion worth of reserves that are in the trust funds at present.

Chairman **Sasser**. Now, let me turn for just a moment to how we've performed under the Gramm-Rudman-Hollings law. What is the average amount of first-year savings or policy reductions that we've achieved since Gramm-Rudman was enacted? And let's exclude these one-time-only savings where we put things off budget or we have pay shifts and that sort of thing. What is the average amount of first-year savings or policy reductions that we've achieved since Gramm-Rudman was enacted?

Dr. **Reischauer**. If we look at solely the permanent types of savings, it has been an average of about $10 billion.

Chairman **Sasser**. About $10 billion?

Dr. **Reischauer**. Per year, right.

Chairman **Sasser**. How do the one-time savings generally compare in the period after Gramm-Rudman was enacted with the period before Gramm-Rudman was enacted? Do you have any data on that?

Dr. **Reischauer**. I think by and large they were bigger and more permanent before Gramm-Rudman-Hollings came along than after. A higher fraction of the total saving after Gramm-Rudman-Hollings is attributable to one-time accounting and timing adjustments.

Chairman **Sasser**. Do you have any percentage figure of that or any dollar figure? My time has expired, so this is my last question.

Dr. **Reischauer**. I do somewhere, and I will get back to you on it.

[The following was subsequently supplied for the record by the Congressional Budget Office:]

As a practical matter, one-time savings have only become significant since the Balanced Budget Act. While one-time savings undoubtedly occurred prior to fiscal year 1986, they were sufficiently small that they were never identified as such. For fiscal years 1987 through 1990, however, about half of the first-year deficit reduction was achieved through one-time savings.

Chairman **Sasser**. All right. Thank you.

Senator Domenici?

Senator **Domenici**. I want to yield to Senator Grassley for his, and I'll take mine later.

Senator **Grassley**. Dr. Reischauer, my first question is for informational purposes, and the background of my interest in trying to get these rosy projections and optimistic view of the future for budgetary purposes under control stems from an amendment—I think it was in 1984 or 1985—that I got adopted, saying that we needed to make public in each report, which you're doing now and have done for a while, how close we are each year to our estimates with the actuals, and getting you to look at that, or OMB to look at that, with the idea that we'd try to come closer in the future, learn how to do a better job of estimating. And I assume that the science of economics can improve. If there isn't, there isn't any hope.

Anyway, in table 8, you show the deficits that have been underestimated each of the last 10 years. So my question to you is a followup of my continuing interest. What has CBO learned from its estimating errors? And have you incorporated what you have learned in your modeling and estimating techniques for the year we're in now—I mean for the years that's coming up, the budget year we're working on, 1991?

Dr. **Reischauer**. Senator, the first point that I would make is that I would not argue that CBO has been significantly better than OMB or significantly better than the Blue Chip consensus forecast with respect to economics. I read the data, both in the last budget of the Reagan administration and elswhere, as showing that CBO has a marginal advantage. But it is nothing to write home about.

Economic forecasting is a very inexact science, as you know. It's an art. It has become more and more difficult as we have become an economy that depends more and more on the vagaries of world economic events. We continually try to improve our estimating techniques. We do not have a specific model of our own. We rely on several commercial forecasting models, with adjustments made by us, and we try and make improvements where we can.

Senator **Grassley**. Well, I guess that's what I'm asking then. Were some of those improvements made based upon what CBO learned from estimating errors in the past?

Dr. **Reischauer**. We are continually reestimating various equations, as all economic forecasters do. I mean, there is an ongoing process of revising the models as new data become available, reestimating the equations or relationships. I think that is just a standard operating practice, both within the administration and at CBO.

Senator **Grassley**. Can you cite for me one little area where you've learned from the past that is going to make us a little more accurate in the 1991 budget? Or are you telling me that what we've learned is that we really can't improve and so we haven't improved our estimating capability?

Maybe I should not put you on the spot, but let's leave it this way: Find one or two and submit it to me in writing. I hope you can find one or two.

Dr. **Reischauer**. There are many areas where we have changed our techniques marginally. But for me to say with great assurance that this is going to make us more accurate would be misleading. We are continually trying to improve by using new statistical techniques. I can provide several examples. They won't be large examples.

[The following was subsequently supplied for the record by the Congressional Budget Office.]

CBO constantly strives to improve the accuracy of its budget estimates. This effort takes many forms:

—Close monitoring of actual spending patterns shown in the "Monthly Treasury Statement" and preparation of month-by-month spending plans for the current year.

Publishing an annual analysis of sources of error in budget resolution estimates.

—Consultation with outside experts, including semiannual meetings on the economy, the agricultural outlook, and world oil markets.

—Greater exposure of the assumptions underlying the budget projections, for example, by publishing crop-by-crop price and quantity data for the farm price support program.

—Continual updating of models to reflect new program data. Partly as a result of efforts such as these, CBO's average and average absolute estimating errors have both declined in recent years.

CBO is especially proud of its forecasting record since 1984. Though statisticians would argue that the small number of times that CBO has conducted forecasts since 1984 cannot provide convincing evidence of the accuracy of its methods, the record still shows that summary measures of CBO's forecasting errors since 1984 have been consistently below those that it compiled earlier. There summary measures of forecsting error have also generally been smaller than the corresponding measures for OMB over the same 5-year period. This statement refers to current-year and 1-year ahead forecasts of growth in real GNP, nominal short-term interest rates, and growth in the GNP deflator.

This strong record comes about in part because of efforts to improve our technical forecasting procedures in several areas. Of these, three are singled out here: the effects of changes in exchange rates on the prices of imported goods in the United States (which contribute importantly to inflation); short-term interest rates; and international trade, which plays a major role in determining GNP.

The contribution of changes in exchange rates to inflation in the United States had previously proved difficult for CBO and other forecasters to predict, since a given change in rates normally gave rise to a surprisingly small change in the prices of imported goods. Recently, however, CBO has instituted a new forecasting equation based on better tracking of foreign prices that has noticeably improved its predictive accuracy in this area. In the area of short-term interest rates, CBO has recently studied the use of "random walks" as a principle on which to base its short-term forecasts and learned that such a procedure is more accurate than several alternative methods. As a result, the random-walk approach has recently had a stronger influence in CBO's short-term forecasts of interest rates than before, and has helped improve their accuracy. Finally, as regards international trade, CBO has recently done extensive research on the use of the principles known as the "absorption approach" to analysis of the balance-of-payments, particularly as this approach is embodied in multicountry econometric models.

Senator **Grassley**. So the only way that Congress isn't going to be in the 11th year, next year, as we sit here, underestimating or being overly optimistic is for us to take your figures and us to make a policy decision we ought to subtract from those if we're going to be closer to reality. Is that basically what you're saying?

Dr. **Reischauer**. By and large, I believe that if you had taken our economic assumptions over the decade, you would have missed the targets in the budget resolutions by less than turned out to be the case. It would still be a very large miss, though. As you are aware, there are two other factors here that cause these targets to be missed. One is policy; the policy embodied in the budget resolution is often not adopted in full by the Congress. The second reason is technical changes, and these account for substantial portions of the error as well.

Senator **Grassley**. On another point, tell this committee what CBO might have done or is doing or how you might intend to analyze for our budget purposes this year the impact of the so-called diminished threat on the defense budget because of the improved relationship between the United States and the Soviet Union. Maybe you haven't, but if you have, I want to know what it is.

Dr. **Reischauer**. Our role in this would be to estimate the impacts of various options that committees of the Congress are considering. We do not work up a particular defense policy that we consider would be a prudent course for American foreign policy. We might produce three, four, or five options—options that are being discussed by members, by committees. We have done a report for

Senator Domenici estimating the impact of the CFE treaty: what would happen if that treaty was concluded, how much budgetary savings might result. We indicated in that report, which was released by Senator Domenici several days ago, that savings on the order of $3 billion a year would result.

The report also laid out several options suggesting that, should the Congress want to go beyond the narrow bounds of the CFE treaty and reduce our forces in Europe by more, savings of a larger magnitude could be realized.

Senator **Grassley**. Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Grassley.

Senator Hollings?

Senator **Hollings**. Dr. Reischauer, I, too, welcome you. We're looking forward to working with you. I'm sure your testimony is one of the few moments of truth that we'll ever experience this year in the budget process.

Let me also commend our chairman. I listened to his statement very closely, and I'm glad to get in step with him because he expresses the same frustration that I have. I'd have one clarification, and that is with respect to the allegation that Gramm-Rudman-Hollings is not working, as the chairman stated, because we are missing the target already this year by some $38 billion. In essence, then, we've slipped the Gramm-Rudman-Hollings law by a year.

Gramm-Rudman-Hollings was never intended to force politicians to tell the truth. I don't know of any law that I could introduce to try to get that done. The Lord tried with the Ten Commandments.

But having said that, I've got one observation which I made in a press conference only yesterday. You've got to change the rewards up here first. We get rewarded for not telling the truth, we get reelected. That's not the case at the local level. Up here it's more complicated. It takes harder work. But if the press were to follow, Dr. Reischauer, your figures, analyze them in news stories as opposed to accepting on faith the estimates given out by us who are engaged in the charade, then I think we could bring us back to reality.

The reality is—isn't it correct, Dr. Reischauer—you've got a $138 billion deficit now, and we missed the target by $38 billion already this year.

Dr. **Reischauer**. That is our estimate at this point.

Senator **Hollings**. That's your estimate right now. At Thanksgiving we were purportedly in step with Gramm-Rudman-Hollings, and now we're $38 billion off target. Then you add, I understand, you estimate $20 billion in expenditures on the S&L bailout. Is that right for this year? You've changed the $10 billion to the $20 billion. You had $10 billion in your book report, but now I think your updated figures, instead of $20 billion next year, you're going to spend the $20 billion this year and the $10 billion next year.

Dr. **Reischauer**. Well, that is off-budget.

Senator **Hollings**. That's off-budget spending. But, I mean, we're going to spend it.

Dr. **Reischauer**. Yes.

Senator **Hollings**. So that's $138 billion plus $20 billion is $158 billion, plus $135 billion in trust funds adds up to $293 billion. So we're spending almost $300 billion more than we're taking in. Now, that's the reality.

Dr. REISCHAUER. But we are taking in money that creates those surpluses in the trust funds.

Senator HOLLINGS. Yes; but, Senator Moynihan called it thievery and Senator Heinz called it embezzlement, I've been calling it a fraud. If it's thievery to take from social security, it's thievery to take from the airport trust fund for the deficit, or from the highway trust fund for the deficit.

So let's go to that proposition of Senator Moynihan's. It's very likely that we've got a majority vote on both sides for capital gains—only parliamentary maneuvers have forestalled it. And it's very likely that those who are voting for a capital gains cut are not stupid enough to vote to raise the taxes on Social Security this year. The social security rollback would be a $55 billion loss. And with an average loss of $5 billion on capital gains, you're looking at adding $60 billion to the deficit. What effect would that have on the economy as you see it? You've got to go borrow some $55 billion at least out of the capital markets; isn't that right?

Dr. REISCHAUER. Well, it is not quite that great because——

Senator HOLLINGS. What lessens it?

Dr. REISCHAUER. There will be some offsets from higher income tax collections. So I think the fiscal year 1991 effect of the Moynihan proposal would be something on the order of $38 billion.

Now, as you suggest, if we do cut social security taxes by that amount and we do not raise other taxes or cut other spending, we will be increasing the deficit by that amount. Increasing the deficit by that amount will inevitably push up interest rates. It will increase our dependence on foreign capital inflows. It will make the job of the Federal Reserve more difficult. And it will retard economic growth to the extent that it leads to lower net national savings.

Senator HOLLINGS. Let me jump, since the yellow light is on, to page 43, chapter 2, of your testimony where you estimated that in 1991 we'd have a $20 billion borrowing for the REFCORP, and now I understand just in the past week you've changed that from $20 billion to $10 billion and transferred the $20 billion over into the present fiscal year 1990. Is that correct?

Dr. REISCHAUER. The off-budget borrowing by REFCORP will be $20 billion in fiscal year 1990, the year we are in right now.

Senator HOLLINGS. Right now.

Dr. REISCHAUER. And $10 billion in 1991.

Senator HOLLINGS. Yes, and you originally had—when you swap around, I know the game is going on. Anybody can mentally play the game of submitting a budget here. The first of the week, the President is going to be submitting that budget. And if he's got to use your figures of $138 billion and come down to $64 billion, then he's looking for some $38, $36, $74 billion. How is he going to find it? That's the big headache, and we're wondering how to do it. Now we see our own CBO swapping around $10 billion. What caused you to do that?

Dr. REISCHAUER. I am not aware that we swapped around $10 billion.

Senator HOLLINGS. Perhaps your staff can tell you. I'm not trying to embarrass you. What I'm trying to do is find out what the fact is, because I was told that you had to do that.

Dr. REISCHAUER. I correct myself. You know more about the details of the inner workings of CBO than I do.

Senator HOLLINGS. Yes; but if that's correct, you've changed from the $20 billion over to this year.

Dr. REISCHAUER. The estimate you are referring to was done a week after the savings & loan bailout bill was passed and before we had the detail involved. It was unclear how the $30 billion worth of REFCORP off-budget borrowing authority would be distributed in the 2 years. Subsequently, the oversight board, RTC, and the specifics of the legislation indicated that the borrowing will be $20 billion in the current fiscal year—done $5 billion a quarter—and $10 billion in the 1991 fiscal year.

Senator HOLLINGS. I just wonder whether that's a Darman maneuver; you know, all of a sudden find $10 billion by changing around, just calling up CBO and saying, well, we'll just up that and that will help us $10 billion worth, you know, to try to meet this crunch coming next week.

Dr. REISCHAUER. No; I understand the thrust of your question, which is that the bailout of the S&L's leaves a lot of room for playing around with the numbers so as to increase or decrease the deficit in any particular year. But I don't think this particular instance is an example of that.

Senator HOLLINGS. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Hollings.

Senator Domenici.

Senator DOMENICI. Senator Gramm, I'd yield to you.

Senator GRAMM. Dr. Reischauer, in listening to your discussion of statistics, I would conclude that you believe the world would be better off without this law we call Gramm-Rudman. I hear the discussion about savings being bigger before, but I was the coauthor in the House of the 1981 and 1982 budgets, and those budgets were certainly better than anything we have written since. I don't remember them as being our options in 1984, 1985, 1986, and 1987.

CBO's projected deficit in 1985 of the deficit in fiscal year 1990 was $296 billion. You're telling us now, even under your assumptions, which are 85 percent of the difference between you and OMB's due to assumptions, that the deficit is $138 billion. That's $158 billion less than you projected, or CBO projected—you weren't there. We won't make those mistakes with you there in the future, I'm sure. But what accounted for the decline, the $158 billion decline? I'm going to put it all in one question, so let me make one other point.

In the middle of the fiscal year this year, we decided to increase funding for the war on drugs by $2.2 billion. We went back and cut other programs by $2.2 billion. Now, I'd like to begin with the fiscal year 1990 projection of $296 billion. The fact is that even though we're way off the target if your number is right at $138 billion—and it may be right—the deficit is still down $158 billion. I've given just a practical example of one thing we did this year which I, at least, assumed could never have happened without Gramm-Rudman, and I'd like to get away from the numbers which can be bent. You know, I can say spending grew by 11 percent a year for the 10 years before Gramm-Rudman; it's grown by 5 percent afterwards; that actually the size of the Government has declined under the Gramm-Rudman law.

But so we don't get into a contest about who can use statistics the best, let me just ask you a question as to what you believe. Do you really believe that we would be better off in terms of the fiscal position of the American Government today if there had never been a Gramm-Rudman law?

Dr. **Reischauer**. No; I think you have misinterpreted my answer to the chairman's question. I actually happen to be a defender of the effectiveness of the Gramm-Rudman . . . Hollings?—I'm not sure—process.

Senator **Gramm**. I'm not letting him off without child support. [Laughter.]

Dr. **Reischauer**. I didn't want to get into a family squabble here. But I agree with you that there has been more deficit reduction because of the strictures of Gramm-Rudman-Hollings, although there has been a lot of gimmickry and phoniness as well.

With respect to your particular example, which was a 1985 estimate by CBO that the baseline deficit would be $296 billion in fiscal year 1990, whereas it is now at $138 billion. A major reason for the reduction that has occurred is that CBO changed its methodology to estimate the baseline in defense. In 1985, we had a real growth in defense budget authority of around 5 percent built into our forecast because that was in the defense plan that the administration, together with congressional actions, seemed to be supporting at that time. Subsequently, we decided that it would be more straightforward to treat defense the same way we treated nondefense discretionary spending—namely, to increase it only sufficiently to take account of inflation. That caused a huge drop in our baseline forecast, because, of course, defense is a big chunk of the total budget.

Nevertheless, the Congress has taken actions, as you pointed out, including partial sequestration this last year, that have, on balance, reduced the deficit.

Senator **Gramm**. Since I'm running out of time, let me be sure I've got the number under your assumptions and projections for the future right. Basically, what you're projecting is that if you took every assumption you're making and you took the current level of spending today—as I understand it, you're assuming revenues are going to grow by $70 billion—that in order to meet the deficit reduction targets, we've got to reduce the deficit by $74 billion. So would that boil down to saying if we spent $4 billion next year less than we're spending now that we would hit the target, even under your assumption?

Dr. **Reischauer**. $4 billion less?

Senator **Gramm**. If we, in the words of the guy in the street, cut spending by $4 billion, even under your assumptions we would meet the target. Is that right?

Dr. **Reischauer**. If you cut spending——

Senator **Gramm**. You're saying revenue will grow by $70 billion.

Dr. **Reischauer**. Yes; $70 billion.

Senator **Gramm**. Spending will grow by $74 billion. OK? So what I'm saying is that if you applied all the revenue to pay for the spending, add it to where you are now, and reduce spending from the current level by $4 billion, you would meet the target under your assumptions.

Dr. **Reischauer**. Correct. But the Congress does not control spending; it controls budget authority. And so it would be very difficult. It would require very severe cuts in budget authority and in certain discretionary accounts, or major changes in fundamental legislation applying to mandatory programs and entitlements to bring that off, especially if you're considering the fact that interest payments are something over which we have virtually no control.

Senator **Gramm**. Thank you, Mr. Chairman.

Chairman **Sasser**. Senator Lautenberg.

Senator **Lautenberg**. Thank you very much, Mr. Chairman.

Dr. Reischauer, I, too, welcome you here. I just want to clear up a couple things that I think are important for the record to reflect.

You said that while economics is an inexact science, nevertheless there are certain permutations that you go through that will come out to a reliable answer, given the correctness of underlying assumptions. Is that not true? Do you want me to restate it?

Dr. **Reischauer**. Well, if you restate it, it might be even more difficult to answer. [Laughter.]

Senator **Lautenberg**. Let me just say it again, because what we're doing here, in all due deference to my esteemed colleague and friend, Senator Hollings, and some of the others—I think what we're saying is that whatever has been done is kind of gimmickry and hokey and all that kind of stuff. And I just want to establish the facts, since in my former life I was one of those purveyors of an economic service, the econometric database that Alan Greenspan used to prepare. I just want everyone to be aware of the fact that if your assumptions underlying interest rates, GNP, those kinds of things, remain static, the science becomes more exact because the formula used is a reliable, almost arithmetic formula, is it not?

Dr. **Reischauer**. If you are asking me about econometric models, what those models do is to take a large body of data about the past for specific economic variables and relate them to each other using statistical procedures to get what, in effect, is an average relationship. Now, in any specific year, the actual relationship may deviate a little from the estimated one, which is a function of past experience. And so I think, even if you told us what underlying variables would be, we would not be able to——

Senator **Lautenberg**. If interest rates are as projected, if GNP growth is as projected——

Dr. **Reischauer**. Yes; then what do you want to know?

Senator **Lautenberg**. Then we're going to get a fairly reliable answer, are we not?

Dr. **Reischauer**. What is the question?

Senator **Lautenberg**. Well, the question is whether CBO or OMB does their forecast——

Dr. **Reischauer**. Oh, we're talking about the impact on the budget.

Senator **Lautenberg**. Yes; because I don't want to hear an apology made for the calculations when, in fact, much of the result is due to assumptions made about certain other factors.

Dr. **Reischauer**. A lot of programs are driven largely by economic variables. There is no question about that. But other factors are involved that have very little to do with economics. When the Secretary of Defense decides to shift the pay date from October 1 to September 30, it moves $2.9 billion.

Senator **Lautenberg**. If we advance foreign aid money, et cetera.

Dr. **Reischauer**. Right.

Senator **Lautenberg**. But the thing that I want to try to establish here is that there is a degree of reliability and that we can't just dismiss CBO's work or even OMB's work based on the way we calculate things but, rather, on some of the assumptions and then the variables that come in. Is that not so?

Dr. **Reischauer**. Right.

Senator **Lautenberg**. So that if OMB forecasts an interest rate that's optimistic or a growth rate that's optimistic, then their projection is going to come out a lot more favorable than one that you might if you are, let's say, excessively pessimistic.

Dr. **Reischauer**. If you gave us, for example, the interest rates, we would be able to predict net interest costs with a very small margin of error.

Senator **Lautenberg**. I don't want this to become too technical. What I want to do is get back to something that the Senator from Texas asked for, and, that is, would you support the notion that G-R-H, in fact, made the budgeting process more reliable, more better, and you said yes.

Dr. **Reischauer**. I think his question was: Did Gramm-Rudman lead to lower deficits than would have occurred otherwise? And that's a judgment call. Nobody can know for sure, but my guess is that it has.

Senator **Lautenberg**. Yes; all right. However, aren't there other factors that helped you draw your conclusion, like increases in the social security revenues, like changes in the way we allocated our FSLIC reserve, other factors, the sale of assets which was introduced—and, frankly, I was one of those who said, OK, we now have this what I'll call illusionary target, and how do you get there? You have to use a magic wand because the original premise of G-R-H was that in 1991, not 1993, we were going to be at a zero deficit level. And what happened is conditions were created that encouraged this fakery, that encouraged this skullduggery. I don't use as colorful phraseology as my distinguished colleague from South Carolina. He said the good Lord handed down the Commandments. One of those Commandments was not that thou shalt not cover thy neighbor's forecast because it's unworthy. But aren't there a number of things that arose in this that affected the outcome of budget planning, having nothing to do with Gramm-Rudman-Hollings?

Senator **Domenici**. Would the Senator yield for a clarification on my time?

Senator **Lautenberg**. Yes.

Senator **Domenici**. Are you asking him for things that change that might not have been expected? You are not assuming that

Gramm-Rudman-Hollings did not expect to treat social security and its reserves precisely as they are being treated, are you?

Senator LAUTENBERG. No; because that was in the matrix at that time. But I am saying that it never assumed sale of assets; it never assumed the volume of revenue increases. There were lots of things that affected the outcome that had little to do with Gramm-Rudman-Hollings. And I don't want to renegotiate Gramm-Rudman-Hollings. If it came to a vote today, I think the outcome would be considerably different.

Dr. REISCHAUER. When we make our estimates of what the deficit will be for, say, fiscal year 1990, which we are in right now, we count all of those things. We do not include the post office because the post office was excluded from the budget. We do not count the deficiency payments that were pushed back into 1989 rather than falling in 1990. We try and make an accurate reflection of what the bottom line number will be when the final monthly Treasury statement is issued.

Senator LAUTENBERG. I'm sorry. My time is——

Chairman SASSER. And you don't take into consideration those matters that have been put off budget.

Dr. REISCHAUER. No, we don't.

Chairman SASSER. Like the S&L bailout.

Senator Domenici——

Dr. REISCHAUER. We provide information for you on how big those are, but they are not included in the $138 billion number that we issue as our expected deficit.

Chairman SASSER. I think the point that Senator Lautenberg is trying to make is that Gramm-Rudman-Hollings encourages occurrences like putting the savings and loan bailout off budget rather than on budget so it will not be counted.

Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman.

Frankly, I don't want to spend all of my time trying to defend Gramm-Rudman-Hollings. It was not my invention, and my good friend, Senator Hollings, is aware of the fact that I didn't like it in the first go-round. Nonetheless, let me clarify something I made in my opening remarks and suggest that we have something to do with whether Gramm-Rudman-Hollings works or not. It isn't all the fault of Gramm-Rudman-Hollings.

I'll put this one in the record. I would ask Mr. Reischauer to confirm it later with your analysis.

[The information of Senator Domenici follows:]

CHANGES IN FY 1989 DEFICIT ESTIMATES

($ billions)

100TH CONGRESS:		
GRH Snapshot (August 15, 1988)		$144.0
Legislation:		
Appropriations (including $0.5 billion for anti-drug supplemental)	+0.8	
Omnibus Trade and Competitiveness Act	+0.3	
Hunger Prevention Act	+0.3	
Manassas Battlefield Park	+0.1	
Other legislation (net)	+(*)	
Subtotal legislation		+1.5
Other adjustments (including debt service)		+0.5
End-of-session total (October 22, 1988)		$146.0
101ST CONGRESS:		
Reestimates (economic and technical):		
Revenues	-20.7	
Spending:		
Defense	+4.0	
FSLIC/FDIC	+6.9	
Other entitlement and mandatory	-3.3	
Interest costs	+11.2	
Subtotal reestimates		-1.8
Legislation/Executive action:		
FMS refinancing	-5.0	
Defense pay shift	+3.0	
1989 Supplemental	+0.7	
Financial Institutions Reform Act	+9.1	
Other legislation	+0.1	
Subtotal legislation		+7.9
Actual 1989 deficit		$152.1

NOTE: Details may not add to totals due to rounding.
(*) Less than $50 million.

Sources: Final OMB Sequester Report for FY 1989 (October 15, 1988)
Letter from OMB Director on final GRH estimate (December 5, 1988)
OMB Mid-Session Review of the Budget (July 18, 1989)
Final Monthly Treasury Statement for Fiscal Year 1989 (October 27, 1989)

Senator **Domenici**. When we finished our work in August 1989, we did what we thought was allowable. Instead of being at a deficit of $134 billion, Mr. Reischauer, my numbers would say we started at $144 billion. So we had already decided that we were going to gamble right up to the $10 billion float. Then we took other policy actions after that, on our own as Members of Congress. We did a hunger prevention act, the Manassas Battlefield Park Act, an antidrug supplemental; all of that added another $15 billion to the deficit. And then we did our reestimating, and interestingly enough, we had underestimated revenues by $21 billion, so we get credit for that. Defense spending was $4 billion more than we estimated; FSLIC cost us $6.9 billion more than we expected; interest costs added $11 billion more than we had expected; the Financial Institution Reform Act cost us $9.1 million more; and a couple of other things.

So when you add it up, essentially we were $16 billion off the mark, most of which was directly attributable to things we ourselves did. And I just would like that clarified.

There are a few other things I would like to follow up on. This question may seem terribly irrelevant, but I want to ask it anyway. As an economist, could you tell me if the United States of America spends 12 percent of her GNP on health care—and let's just assume for round numbers that our gross national product is $5 trillion. My arithmetic would say we spend $600 billion on health care.

Incidentally, I just happen to look that number up, and that makes our health care the eighth largest economy in the world and gaining quickly on Italy. We will pass Italy shortly, I say to my friend. They can't possibly have their GNP grow as fast as our health care costs. So we will be the seventh largest economy next year, our health care costs alone.

But now let me finish the question. Japan spends 5.5 percent of their GNP on health care. And if my arithmetic is right, that means that every Japanese car coming off the assembly line has some health care costs figured into it. I tried to find out how much. I think it's $225. Every American car coming off the assembly line has another little piece of paper in the back, and it says this car has $500 worth of health care cost in it.

Now, when we're speaking of competitiveness, proper allocation of our resources, accumulating savings so we can make capital investment, and the like, is it relevant to America's future competitiveness that we spend more than two times as much on health care as Japan? Now, I'm not trying to cheat here. I can tell you every other free industrial nation is substantially lower than the United States. And for those who think Canada is high, I'll give you the number. It's 8 percent GNP, we're 12 percent.

But I'm beginning to wonder whether we're looking at the right issues when we talk about accumulating savings for future growth if we do not look at economic inefficiencies. Could you just give me a quick answer on that?

Dr. **Reischauer**. OK. But I don't think that the quick answer is going to please you.

Senator **Domenici**. OK.

Dr. **Reischauer**. The real issue is not how much we spend versus other countries on health care but, rather, on total compensation.

Senator **Domenici**. For what?

Dr. **Reischauer**. Total compensation, which would be made up of wages plus fringe benefits. Whether American workers choose to take a larger fraction of their total compensation in the form of health insurance or pensions or whatever is really immaterial. What matters to Nissan and what matters to GM is what they have to pay for an hour's worth of labor, which is the total compensation issue; and how productive that labor is.

I am as concerned as you are about the tremendous growth in health care costs in this country, and I think it is an issue that should be addressed. But I don't think it feeds in a first-order way into the issue of competitiveness. Now, we may have a terribly inefficient system. That is a different issue. We also have a system that has some, shall I say, strange distributional qualities in the sense that we spend more than any nation in the world on health care, and yet there still is a substantial portion of our population with no health care insurance at all.

Senator **Domenici**. But just staying on the industrial side, unless that rather excessive relative cost reflects itself in the costs of an hourly wage versus the productivity?

Dr. **Reischauer**. Well, yes.

Senator **Domenici**. OK.

Dr. **Reischauer**. What it suggests is that American workers' take-home pay won't be growing as fast because more of their total compensation each year is being eaten up by this health care monster.

Senator **Domenici**. OK. My last question—and I thank you for bearing with me—Mr. Reischauer. We have had a lot of discussion about the Social Security Trust Fund and its accumulated balance. I have read some quotes from the 1983 commission, and I have read some quotes made by Senator Daniel Patrick Moynihan in 1988 regarding this whole issue.

Now, let me ask you, is it thievery, is it fraud, the original intention of the Social Security Commission and the proponents of Gramm-Rudman-Hollings—and Senator Daniel Patrick Moynihan, as late as 1988, said we will get the deficit down to zero under Gramm-Rudman-Hollings, and then we will begin to buy down the accrued Federal deficit so as to force savings and hopefully increase America's competitiveness by diminishing our debt.

Is that thievery, chicanery, fraud, or is that a forthright economic theory that made sense then and makes sense now?

Dr. **Reischauer**. I am not into crime control, so I would not want to characterize that as thievery or anything else.

Chairman **Sasser**. A wise judgment, Dr. Reischauer.

Dr. **Reischauer**. But let me——

Senator **Domenici**. Well, let me say if they called it thievery, is it thievery?

Dr. **Reischauer**. The notion that payroll taxes would be raised so that we were bringing more money into the Social Security System than we were spending in benefits each year, and that this additional surplus would add to national saving, I think, was a correct decision then and it remains a correct decision now.

The question before the Congress is whether this is adding to national saving or is it masking excessive spending in other parts of the budget? I think you have to ask yourselves, if we did not have that surplus, would we be out there raising income taxes or other taxes or cutting other spending by $66 billion, or would we be living with a larger deficit.

Given the track record of the last few years, it is hard to argue, I think, that we would be out there increasing income taxes and other taxes or cutting nonsocial security spending by large amounts.

Senator DOMENICI. Thank you very much.

Chairman SASSER. Senator Simon.

Senator SIMON. Thank you, Mr. Chairman. If I may just comment on the last item, I think Senator Moynihan has made a contribution. I don't happen to agree with his conclusion, but there is no question we are using Social Security Trust Funds to mask the reality of the deficit. The deficit, in fact, is substantially greater than the public perception, and so I join my colleague, Senator Sanford, and others in seeking statutory changes to shift that.

And I would just add Senator Moynihan had either GAO or CRS do a study and said what would happen if, in fact, we balanced the budget and had social security reserves separately. What would happen in our economy?

Their projection was, within a matter, I believe, of 6 years, we would have prime rate at 3 percent and have a huge stimulus to our economy. Now, they may be off in those projections. You know, no one can say precisely, but there is no question this economy would be in significantly better shape if we took social security off the budget and then balanced the budget, and it is one of the reasons I favor a constitutional amendment because we have shown clearly we don't have the discipline to do it on our own.

Let me add, however—and let me just also welcome you here. I was very pleased when I heard about your appointment. I had the chance to observe you when I was on the House Budget Committee, and was very impressed by your work.

There is another area where we mask what is happening, and that is the way we list interest rates. And, here, I would be interested in knowing from you—I have been getting conflicting advice—whether we can shift—when we list interest, list is as gross interest and then list the interest that is earned as part of revenue. Then we get an honest picture. That is what we are not getting now.

And, here, I would point out the fastest growing item in the Federal budget by far is interest. In fiscal year 1980, the gross interest expenditure was $74 billion. This last fiscal year, it was $234 billion. This year, it will be somewhere in excess of $263 billion.

Next year, for the first time in the Nation's history, the number one expenditure of the Federal Government will be interest, past defense. Now, we ought to know that, but we are masking it.

And if I could just use as an illustration—and I am not picking on you here—I want to know, number one, how do we get it changed. Is it just a matter—if the chairman and ranking member get together with you and say let us list gross interest and change the way we list it, do we need a statutory change?

And just to illustrate the point, at page 14 where you have table 5, Increased Interest Costs, those are obviously net increased interest costs. The real interest costs are substantially greater than that.

Now, you have my question and my assertion. Any comments? How do we change this?

Dr. REISCHAUER. Let me go back to one of your earlier assertions, about all of the good things that would transpire in our economy if we were to balance the nonsocial security part of the budget and allow the social security surplus to remain.

Those estimates—and I am not speaking for their accuracy because they were done by other organizations—would be unchanged if we cut social security taxes back so that social security ran on a pay-as-you-go basis, but at the same time increase other taxes or cut other spending sufficient to produce an overall surplus equivalent to the example you gave that would be a surplus in the overall activity of the Federal Government that rose to $128 billion by 1995.

So it really is not a function of which funds we are building up or depleting. It is the overall picture that matters from the standpoint of the economy. Now, you might argue that politically it would be impossible to convince the American people to run a large surplus in the balance of the budget; that they can understand saving for retirement, in a sense, and so this is a——

Senator SIMON. I think that is a political reality, yes.

Dr. REISCHAUER. OK. Your second question dealt with what would it take to change.

Senator SIMON. How do we——

Dr. REISCHAUER. In the report that we are issuing on January 31, we will present the gross interest on the public debt, as well as the net interest. What you are suggesting, I think, is that there be a separate budget function, and that that function not be net interest, but rather that it be, maybe, divided into gross——

Senator SIMON. But what we do when we list interest is we end up listing the net interest.

Dr. REISCHAUER. Yes; but there are a lot of other places where receipts and collections flow into the budget offsetting expenditures.

Senator SIMON. I understand, but nowhere near the kind of numbers that we are talking about on interest. And so what I want—in addition to pulling social security off, I want to shift to, when we list interest, that it is gross interest and not net interest, so that we do not have the kind of situation like on table 5 on page 14, so that we get a more accurate look at what the situation is.

Now, that doesn't change the bottom line, but it makes us a little more aware of what we are doing with this huge deficit. What I want to push—and I want an answer from you, not right now, but an answer from your—send me a letter, and I want to push so that when we come out with our budget package, we are going to have gross interest and not net interest, so we can really see what this deficit is doing to us, OK?

Dr. REISCHAUER. But where is the inflow going to be reflected in this?

[The following was subsequently supplied for the record by the Congressional Budget Office:]

The Office of Management and Budget determines the allocations of Federal Government spending into budget functions. At present, budget function 900, net interest, records Federal interest payments to the public. Net interest is currently divided into four subfunctions—gross interest on the public debt, interest received by on-budget trust funds, interest received by off-budget trust funds, and other interest receipts (primarily interest income received by the government on loans and cash balances).

Senator SIMON. Well, as you list revenues, obviously, there is some interest revenue, and if you want to list that separately, that is fine with me. But I want to see that gross interest picture. I want to see an accurate portrayal of what is happening on interest expenditures by the Federal Government, and we are not getting that now.

Chairman SASSER. Thank you, Senator Simon.

Senator Nickles.

Senator NICKLES. Thank you, Mr. Chairman.

Dr. Reischauer, I have a couple of questions, too. One, you mentioned the social security trust surplus would equal $66 billion in 1991?

Dr. REISCHAUER. In 1990.

Senator NICKLES. In 1990?

Dr. REISCHAUER. And $74 billion in 1991.

Senator NICKLES. What is the total trust surplus—if you added all of the other trust funds that are running surpluses—what would that total be for 1990 and 1991 as well?

Dr. REISCHAUER. The total trust fund surpluses for 1990 would be $132 billion. In other words, social security is a little less than half. And for 1991, the number would be $136 billion.

Senator NICKLES. And social security for 1991 is how much?

Dr. REISCHAUER. It will be $74 billion.

Senator NICKLES. If we are talking about making changes ala social security off budget and taken out the Gramm-Rudman figures, should we do the same thing for the Highway Trust Fund, the Airport Trust Fund, the Black Lung Trust Fund the Civil Service Retirement Trust Fund, and all the other trust funds combined? I mean, isn't the analogy——

Dr. REISCHAUER. You have just given what, for me, is one of the very convincing arguments why you should not do it for social security.

Senator NICKLES. I understand that. Do you have a chart included with your statement—I didn't see it—with all of the other trust funds listed? Would you provide that for us?

Dr. REISCHAUER. It is in the report that we are going to be issuing on January 31, but we can provide it to you sooner than that.

Senator NICKLES. I appreciate that.

[The following chart was subsequently supplied for the record by the Congressional Budget Office:]

TABLE II-6. TRUST FUND SURPLUSES IN THE CBO BASELINE
(By fiscal year, in billions of dollars)

Trust Fund	1990	1991	1992	1993	1994	1995
Social Security	66	74	85	98	112	128
Medicare[a]	21	18	18	16	15	14
Military Retirement	13	14	14	15	15	15
Civilian Retirement[b]	20	20	22	22	24	25
Unemployment	7	5	4	4	3	3
Highway and Airport	3	1	c	c	-1	-1
Other[d]	3	2	2	2	2	1
Total Trust Fund Surplus	132	136	145	157	170	185
Federal Funds Deficit	-270	-273	-280	-297	-299	-303
Total Deficit	-138	-138	-135	-141	-130	-118

SOURCE: Congressional Budget Office.

a. Hospital Insurance and Supplementary Medical Insurance.

b. Includes Civil Service Retirement, Foreign Service Retirement, and several smaller funds.

c. Less than $500 million.

d. Primarily Railroad Retirement, Employees' Health Insurance and Life Insurance, and Hazardous Substance Superfund.

Senator NICKLES. Incidentally, I have made speeches on trust funds and trust fund surpluses, and I think Senator Sanford and I have made similar statements dealing with trust funds. We may have a different approach now; I am not sure. But I think there is a great deal of misinformation about what happens with the trust funds and what we should do about them. It is a debate that needs to happen.

Your baseline is adjusted for inflation, all accounts. You are assuming inflation adjustments for appropriation accounts, is that correct?

Dr. REISCHAUER. Correct.

Senator NICKLES. Many of us are on the Appropriations Committee. Some of us would like to have an inflation adjustment for all of our accounts, but sometimes we don't get it.

I happen to think the baseline should be computed without an inflation adjustment unless mandated by law. Do you have a chart that would show the baseline without inflation unless it is mandated by law?

Dr. REISCHAUER. Yes, we do, and in my testimony there was a table that showed——

Senator NICKLES. I saw a table that showed defense minus CPI minus two, and defense minus CPI minus four, but I didn't see everything.

Dr. REISCHAUER. If you go to page 14 of my prepared statement, the bottom panel of the table on that page shows you the inflation adjustments in discretionary programs broken down by defense purchases, pay, and nondefense purchases and nondefense pay. So, that gives you——

Senator NICKLES. Well, that is only on defense. What about——

Dr. REISCHAUER. No, no. Down below, it says defense purchases, defense pay, nondefense purchases. Page 14.

Senator NICKLES. I am with you, so that would include any of the other appropriations?

Dr. REISCHAUER. Nondefense purchases would be all of the appropriation accounts not involving personnel, for which we have provided a GNP implicit price deflator adjustment. So just by washing out that $11 billion in 1991 from our deficit number or from the amount that the Appropriations Committee had to work with, you would have——

Senator NICKLES. So I could use that $11 billion and $28 billion to get to the baseline?

Dr. REISCHAUER. Yes, $27 billion; $38 billion minus $11 billion.

Senator NICKLES. OK.

Dr. REISCHAUER. The deficit would be $127 billion.

Senator NICKLES. Let me ask just very quickly—and I missed part of your opening statement, but you estimate the deficit for 1990 at $138 billion?

Dr. REISCHAUER. Correct.

Senator NICKLES. In November when we passed the reconciliation bill, we said that we thought it was going to be around $100 billion, if I remember. Did you agree with us when we passed that?

Dr. REISCHAUER. No, we didn't. But remember, when you are working on a budget and scoring for a budget resolution, you are using the economic assumptions that were embodied in that resolution.

Senator **Nickles**. I understand. Well, let me ask you very quickly—my time is almost up—could you outline the difference between the $138 billion and the 100 billion for 1990? I mean, we are talking about a difference of $38 billion for a year that is already 4 months into existence. There is $38 billion difference for this year.

I think we have to try and figure out where we are for 1990. I remember many of us thinking that reconciliation was going to get us within that $100 to $110 billion last November. We are now only 2 months from that point. I am not ready to concede that the deficit is going to be $138 billion for 1990. If it is, I want to at least be in agreement before we really start working on 1991.

Can you give us a very quick rundown on the differences between your $138 and the $10 billion that Congress passed?

Dr. **Reischauer**. I think that at the time you were leaving in November there was a feeling even at OMB that the legislation that had been enacted was not going to produce a deficit of $100 billion. I think the deficit was felt to be in round numbers, close to $10 billion above that.

Senator **Nickles**. Well, there is a big difference between $110 billion and $138 billion.

Dr. **Reischauer**. Yes; at that point our estimate was somewhere in the neighborhood of $128 billion for what had transpired. For technical and economic reasons, we have come up $10 billion from where we were in November, but I will be glad to provide you with a breakdown of where we were and where OMB was in November and where we are now, and why.

[The following was subsequently supplied for the record by the Congressional Budget Office:]

When the Congress completed action on the fiscal year 1990 budget in November, CBO estimated that the 1990 deficit would be $128 billion. Since then, CBO has upped its deficit estimate by $10 billion—to $138 billion. This increase is dominated by higher outlays for deposit insurance, which result from additional spending for troubled banks, the outlay of money appropriated for savings and loans in 1989 but not spent, and a reduction in receipts from borrowing from the off-budget Financing Corporation. Over the same time period, OMB has inceased its 1990 deficit estimate from $110 billion to $122 billion, and the difference between the two agencies' estimates has decreased slightly.

Senator **Nickles**. I would appreciate it, if you would. Thank you very much. Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Nickles.

Let me take about 10 seconds and correct what I think may be a misconception, Senator Sanford, if I may.

A moment ago, Dr. Reischauer, you indicated that it was pointed out to you, I think, in 1985 CBO was projecting a 1991 deficit of $296 billion, and you are now projecting $138 billion.

The difference in those projections in 1985 and today is largely a result of changing the defense baseline from 7 percent growth, which was anticipated then as current policy, down to, what, 2 percent below——

Dr. **Reischauer**. Down to zero growth.

Chairman **Sasser**. Zero.

Dr. **Reischauer**. But in fact, since 1985 the appropriation bills passed by the Congress have reduced defense budget authority by something in the neighborhood of 12 to 14 percent below a baseline that only reflected inflation, and not all of that has been manifest in lower outlays, which is what, of course, the deficit reflects. But Gramm-Rudman-Hollings has been an important contributor as well.

Chairman SASSER. Right. Well, I just wanted to correct what I thought was the misconception that the $168 billion savings, or the discrepancy between your projection in 1985 and the projection now, the $168 billion discrepancy, was the result of the operation of Gramm-Rudman-Hollings, which I thought might have been the import of the question.

Dr. REISCHAUER. No. I might have been misinterpreted, but I was trying to imply that the largest contributing factor was, as you point out, the change in the methodology that we used.

Chairman SASSER. Now, secondly, the question was propounded to you that we could fill all of the $70 billion hole if we just used the increased revenues that were projected for fiscal year 1991.

Now, it is true, in order to fill that hole, you have to have a hard freeze down the line; in other words, cut $16 billion from social security—there would be no COLAs; $12 billion from medicare—there would be no medicare increase in the cost of living; cut the $5 billion COLA increase for Federal retirees; $6 billion from medicaid; $12 billion for defense. And you wouldn't even be able to pay the increase in interest on the indebtedness if you do that. Isn't that an accurate assessment?

Dr. REISCHAUER. It would be even tougher than you are suggesting. If we froze social security outlays at their 1990 level at the same time that the number of beneficiaries is growing, we would have to cut in nominal terms the benefits received by the beneficiaries.

Chairman SASSER. Right. Well, I just wanted to correct what I thought might have been the misconception that it was so easy just to take the increased revenues and put them in the deficit hole. Those increased revenues are already, by law, in many cases dedicated to social security, medicare, medicaid, agriculture entitlements, et cetera.

Senator Sanford.

Senator SANFORD. Thank you very much, and thank you for being here. I didn't find the figure—I am sure it is in here somewhere—what is your prediction of the increase in the national debt?

Dr. REISCHAUER. It is in our report. It isn't in any of the materials that I have given you. As you know, there are a number of different debts to which we refer.

Senator SANFORD. I am talking about the one subject to the ceiling.

Dr. REISCHAUER. The one subject to the ceiling will, we estimate, be $3.084 trillion in 1990, and it will rise to $3.351 trillion in 1991.

Senator SANFORD. So over $300 billion?

Dr. REISCHAUER. Over $3 trillion.

Senator SANFORD. That is the total debt. What is the increase?

Dr. REISCHAUER. The increase will be slightly under $300 billion.

Senator SANFORD. Yes; so, in effect, we will increase our debt by approximately $300 billion?

Dr. **Reischauer**. Yes; I think $270 billion is the actual figure.

Senator **Sanford**. When will we have to increase the debt ceiling again?

Dr. **Reischauer**. That kind of estimate is, of course, rather uncertain, but we think some time around September or October 1990.

Senator **Sanford**. Of this year?

Dr. **Reischauer**. Of this year, yes.

Senator **Sanford**. We increased it last October.

Dr. **Reischauer**. Correct.

Senator **Sanford**. We will have to increase it again in September by over $300 billion.

Dr. **Reischauer**. Yes.

Senator **Sanford**. Now, what I want to raise with you—and I agree with the chairman and I agree with Senator Hollings that there is hardly too harsh a word for what we are doing in concealing the true state of the budget. You could say kindly that it is an Alice in Wonderland definition of budget. What is the budget? It is what I say it is. What is the deficit? It is what I say it is.

But I think it is fraudulent because I think we are misleading the American public when we constantly tell them we are reducing deficits when, in truth, we are not. Here, we have an increase in debt of $300 billion. If we are reducing deficits, why have we got to increase the debt ceiling again?

Here is my question, picking up a little bit on what Senator Simon said, but a little bit more broadly. Who defines "deficit," as we use it? Who authorized us to take the interest that is paid to social security and count it as a receipt? Who authorized us to shift dates across the calendar line of the fiscal years? Who authorized us to do all these little gimmicks? Who autohrized us to hold back highway funds and count that as income and available funds when, in truth, they are not?

Now, we don't subject the U.S. Government to the usually accepted or generally accepted accounting practices. If we did, that would certainly force a degree of honesty that we are not accustomed to.

But any general accounting approach would treat the bottom line of the Federal government as the increase in debt subject to the limitation. That is the deficit.

Who gave us the authority to use all of these gimmicks? It is not in the statutes that I can find, except for using social security. Who defined "deficit" for us, this phony deficit figure we use?

Dr. **Reischauer**. I would disagree with your characterization of the deficit.

Senator **Sanford**. Well, phony or inaccurate or nonaccounted.

Dr. **Reischauer**. I will go back to that in just a minute. The President's Commission on Budget Concepts in 1967 laid out a series of revisions on how we were going to present the budget, and the administration accepted those and has presented the budget——

Senator **Sanford**. When was that?

Dr. **Reischauer**. 1967.

Senator **Sanford**. Sixty——

Dr. **Reischauer**. 1967 was the last revision of this sort.

Senator **Sanford**. Can I have a copy of that?

Dr. **Reischauer**. Let me just comment on the notion that the deficit that we portray in our budget documents is phony or masked.

Senator **Sanford**. Oh, no, I don't want you to use my time discussing that.

Dr. **Reischauer**. Maybe I can get some time later.

Senator **Sanford**. Yes; I want to know who defined "deficit," because it is not defined according to general accounting principles. Who defined it? By what right are we using this kind of deficit figure, phony or not?

Dr. **Reischauer**. The executive branch defines it.

Senator **Sanford**. Very good, and you track the executive branch?

Dr. **Reischauer**. Unless there is a redefinition by action of the Congress, we do.

Senator **Sanford**. Well, that is my point. Thank you very much, Mr. Chairman.

Chairman **Sasser**. Thank you very much, Senator Sanford.

Senator Robb, who has been waiting patiently now for almost 2 hours.

Senator **Robb**. Thank you, Mr. Chairman.

Dr. Reischauer, I was going to ask questions very similar to the one that Senator Sanford just asked, but with a little different twist. But given your eagerness to address that question, I am afraid I will lose my second question. So I am going to start with question number two first.

I really don't want to play the numbers game at this point, except in one area, and that is the question of the potential exposure, the unfunded liability, all of the various ways that the Government could incur liability. I think the General Accounting Office put out a report that—I believe the figure was $5 trillion, or whatever it was. I have seen much larger numbers that various individual economists or those who are concerned about the potential exposure of the United States to liabilities—they are not specifically included—of what those might be.

Do you have a number—and, incidentally, we have attempted to get some input on this and found that it is relatively difficult from any of the entities of Government—do you have a number that you can agree upon at this point that represents an accumulation of the worst case scenario in terms of potential exposure or liability of all of the ways that the U.S. Government might be held accountable for any contingency that might develop?

I realize this is an unrealistic number in its total, but just a starting point. Is there such a number, and do you happen to have it?

Dr. **Reischauer**. I have a set of numbers here. If you have a calculator, we can reach the bottom line. It would include $50 billion worth of exposure from the guaranteed student loan system, $150 billion in——

Senator **Robb**. Is that in your report?

Dr. **Reischauer**. No.

Senator **Robb**. Could you provide that for me?

Dr. **Reischauer**. I will provide it.

[The following was subsequently supplied for the record by the Congressional Budget Office:]

The following table of commitments and contingencies of the U.S. Government is taken from the consolidated financial statements of the U.S. Governmnt, fiscal year 1988 prototype, as published in the September 1989 "Treasury Bulletin," Commitments are defined as "long-term contracts for which appropriations have not been provided by the Congress and undelivered orders which represent obligations." A contingency is a liability where the amount of possible loss is uncertain. "Total contingencies," the report states, "represent the maximum risk of exposure without regard to probability of occurrence."

COMMITMENTS AND CONTINGENCIES OF THE U.S. GOVERNMENT FOR THE YEARS ENDED SEPT. 30, 1988 AND 1987

[In billions of dollars]

	Amounts outstanding	
	1988	1987
Commitments:		
Long-term contracts:		
Tennessee Valley Authority	5.7	6.7
Defense	5.5	1.8
General Services Administration	3.0	2.9
U.S. Postal Service	1.9	1.4
Energy	.4	.3
Other	.8	.4
Subtotal	17.3	13.5
Undelivered orders:		
Housing and Uran Development	195.1	202.3
Defense	167.6	173.6
Funds appropriated to the President	36.2	37.2
Transportation	33.4	34.5
Health and Human Services	31.8	24.2
Other	61.0	57.1
Subtotal	525.1	528.9
Total commitments	542.4	542.4
Maximum risk exposure for contingencies:		
Government loan and credit guarantees:		
Housing	673.9	650.0
Veterans benefits	65.2	65.9
Education	53.1	48.5
Farm ownership and rural development	10.1	7.2
Other	86.3	73.4
Subtotal	888.6	845.0
Insurance in force:		
Federal Deposit Insurance Corporation	1,682.8	1,605.7
Federal Savings and Loan Insurance Corporation	972.5	898.0
Transportation	201.8	162.2
Federal Emergency Management Agency	168.8	158.7
National Credit Union Administration	157.3	148.7
Nuclear Regulatory Commission	72.5	87.5
Other	36.5	59.8
Subtotal	3,292.2	3,120.6
Unadjudicated claims:		
Energy	304.2	10.1
Transportation	39.6	40.0
Other	21.7	25.4
Subtotal	365.5	75.5

COMMITMENTS AND CONTINGENCIES OF THE U.S. GOVERNMENT FOR THE YEARS ENDED SEPT. 30, 1988 AND 1987—Continued

[In billions of dollars]

	Amounts outstanding	
	1988	1987
Other contingencies:		
Veterans benefits	10.1	14.1
Multilateral development banks	4.3	4.4
Other	9.3	10.4
Subtotal	23.7	28.9
Total	4,570.0	4,070.0

Senator ROBB. Could you just give me a total right now, because I don't want to parse all the numbers individually? I don't think that is a productive use of our time. I want to ask a couple of questions that go to philosophical points. Is there an approximate number?

Dr. REISCHAUER. Four-and-one-half trillion dollars.

Senator ROBB. Four-and-one-half trillion is——

Dr. REISCHAUER. That is my approximation of the sum of some numbers.

Senator ROBB. OK.

Dr. REISCHAUER. We are in that neighborhood. That includes potential exposures such as if all guaranteed student loans defaulted. It is not the unfunded liability that the Government might have for outstanding commitments, such as the unfunded liability in the social security system, for which I have seen estimates ranging up to $6 trillion alone.

Senator ROBB. Have you attempted to put that into some manageable number that we could simply look at? Again, I recognize that it is not a realistic number, certainly, as it is added up, but I have a question about——

Dr. REISCHAUER. It would be adding apples and oranges, not to mention hedge hogs or something very different.

Senator ROBB. OK.

Dr. REISCHAUER. Take, for example, the $200 billion in outstanding flood and crop insurance. This would assume that the ice cap melted.

Senator ROBB. Well, you can put them all in an individual line and you can give some threat assessment, if you will, some risk assessment.

The question I have, I guess, has to do with the way of preparing for contingent liability of whatever sort. Is there a mechanism that either has been devised or could be devised that would be something akin to what, say, the banking community would do with a set-aside reserve for nonaccruing accounts, anything that was in a classified account, something that represented a realistic assessment of the degree of exposure, either based on a percentage basis on individual lines or the total amount, so that we could start to address the question that has to do with this definitional question of what is the deficit and what ought to be the definition?

Is there a way to provide for some sort of a rainy day fund to account for all of the individual liabilities that cannot be specifically set out in a line-item budget?

Dr. **Reischauer**. The answer to that, of course, is that we don't do it now.

Senator **Robb**. Well, I understand we don't do it.

Dr. **Reischauer**. We could improve the situation in a number of ways. One of them would be to adopt some credit reform proposal similar to the one that the Senate approved several years ago, and similar to the one that is included in our new credit budget reform report. That proposal suggests putting aside funds to back up the possibility that guaranteed loans might go bad.

Senator **Robb**. The whole concept, though, has been, I won't say avoided, but has not so far been incorporated, is that correct, in any of the budget planning?

Dr. **Reischauer**. Yes.

Senator **Robb**. All right. Let me go, then, back to the question that goes closer to home because I would be interested—and I am not sure, with Senator Nickles' question, that we really are all in the same ball park in terms of whether we ought to be concerned about deficits, I think, is where the bottom line is.

The definition that I think Senator Sanford—and he can certainly correct me if I am wrong—that he and I would agree with is the deficit really ought to be the annual increase in the debt, something that straightforward.

Now, I think that I hear you both here and in prior statements, and others, suggesting that that is not really what we ought to be concerned about. We ought not to be concerned about the fact that all of these trust funds are included to mask the size of what many of us regard as the true deficit; that we don't need to be concerned about the obligations for outyears. We are simply looking at the economic flow in a current year to describe that particular year, notwithstanding the fact that, again, you may be obligating yourselves to tremendous interest or pay-back or, in the case of the Social Security Trust Fund, the assumption that we are creating a corpus, which, in fact, we are not.

Any thoughts on should the definition be what many of us think is a much more honest portrayal, or is there some fundamental economic reason why we ought to get off that kick altogether?

Dr. **Reischauer**. There is a fundamental economic reason why you should get off the kick altogether——

Senator **Robb**. I would be pleased to be convinced.

Dr. **Reischauer** [continuing]. And that is the deficit from the standpoint of the economy, what matters to the economy. What makes bond traders in Tokyo wake up, what makes people on Wall Street concerned, is the total drain on the economy that the Federal Government is going to impose because its spending exceeds the total amount of revenue it brings in in a given year. That number will determine whether Federal activity is stimulative, adds, to or subtracts from economic activity.

Senator **Robb**. In other words, it is a straight current accounts approach.

Dr. **Reischauer**. That is something of a separate issue, which I think is motivating your concern and others', the issue being have we in some sense tricked the American people when we ask them, for example, to pay a dollar a gallon more on highway taxes that we say will be spent on improved highways, and then we don't spend it. The same issue arises when we raise payroll tax revenue so we can give it to taxpayers' parents and grandparents in benefits. It may be that this kind of deception has happened, but from the economic perspective the deception is immaterial.

I would also suggest with respect to the Social Security Trust Fund, that it really should not be of tremendous concern to those paying taxes now. What is important from their perspective is how healthy, how large the economy will be in the next century when we have to pay benefits. The only way we are going to pay benefits is out of the resources available at that time, and those resources will be determined by the rate of economic growth between now and then. Anything that adds to national savings will improve that outlook.

Senator **SANFORD**. You are arguing for pay as you go on social security.

Dr. **REISCHAUER**. I am not going to get into whether it should be pay as you go or not pay as you go. But what I would argue is that we know a large group of people will be retiring who are going to impose a burden on the public sector.

As a result, this nation should be saving more now. Aggregate saving should be more. We don't know very well how to improve private saving. We do know quite well how to increase saving from the public sector, and the answer is to reduce the deficit. It doesn't matter how you reduce the deficit.

Senator **SANFORD**. Which deficit?

Dr. **REISCHAUER**. The deficit that I am talking about is the one that matters because it determines whether government action——

Senator **ROBB**. The deficit is what I say it is.

Senator **SANFORD**. If we go on borrowing money——

Dr. **REISCHAUER**. No; the difference between the revenues brought in by the Federal Government from all its taxes and all its activities versus the expenditures that the Government makes for all of its various activities is what matters.

Senator **SANFORD**. Well, isn't that the increase in the debt?

Dr. **REISCHAUER**. No; it is the increase in the debt held by the public.

Chairman **SASSER**. Dr. Reischauer——

Dr. **REISCHAUER**. Suppose we broke the Government down the middle and created two separate funds. In one fund we put social security and a bunch of small programs and say we are going to dedicate to this fund all of the income tax revenue, all of the corporate tax revenue, and the highway tax revenue. Then suppose over here we put everything else in the Government and dedicate no revenues to it.

We would then have a situation in which one fund had a tremendous deficit; the other one had a tremendous surplus. Would that really matter? Does it matter how we divide the revenues? No.

Senator **ROBB**. Mr. Chairman, I realize that my time is expired.

Chairman **SASSER**. Senator Robb, your time is expired.

Senator **ROBB**. Mr. Chairman, could I simply make a request?

Chairman **SASSER**. Yes.

Senator ROBB. I think we have a fundamental question, a fundamental disagreement in terms of how we approach the much broader question that we are dealing with here and all the individual pieces and components of it.

If it would be possible to have a meeting that you might schedule to address just the question that we are addressing right now, I think that is going to continue to haunt us throughout the rest of these deliberations if we can't come to some accepted common definitions.

I know in State government, if you couldn't come to some agreement on the mechanism and the kinds of revenue projections you were dealing with, as well as the consequences you could never come to closure on the detailed matters.

Chairman SASSER. In other words, what you want is a definition of terms.

Senator ROBB. Something that at least addresses what I think is a fundamental difference in terms of the way we approach it.

Chairman SASSER. Well, I think we ought to consider that.

Senator ROBB. Thank you, Mr. Chairman, and thank you, Dr. Reischauer.

Chairman SASSER. Thank you, Senator Robb.

Let me shift gears here just a moment, Dr. Reischauer, and ask you some questions about our defense spending. Now, it is no secret that the tensions between ourselves and the Soviet Union are immeasurably lessened from where they were 3 or 4 years ago.

I have seen statistics that indicate that something like one out of every three engineers or scientists are employed by the Department of Defense or by defense industries or industries related to defense. Now, that means somewhere around 30 percent, give or take a few.

Now, you look at Japan and you find that 1 percent of their engineers and scientists are involved in defense or defense-associated industries. Four percent of West Germany's engineers and scientists are involved in defense or defense-related industries.

Now, my question to you is, as international tensions continue to abate, and if we are successful in substantially lowering defense budgets and there are fewer engineers and scientists and fewer blue collar workers, for that matter, involved in defense-related industries, what impact is that going to have, in your view, on medium to long-term growth in this economy, and to the competitiveness of the American economy?

Dr. REISCHAUER. I think your figures of 30 percent or a third of engineers involved in the defense sector is probably a bit high, but I think the point is well made.

Chairman SASSER. Well, I think CBO says 20 percent, but I have seen other figures that say 30 percent, 33 percent.

Dr. REISCHAUER. It is certainly true that a much higher fraction of our scientific and engineering talent is channeled into the defense sector than in any other country in the world.

As those skilled workers were released, certainly it would increase the capacity of the nondefense sector, which, in theory, might lead to improved outlook for growth. However, I would put this as a second- or a third-order impact of any peace dividend.

For competitiveness, for growth, the much more significant factor would be whether this peace dividend can be translated into deficit reduction, lower interest rates, increased national saving. Certainly, the reallocation of skilled human capital would be a plus, but it would also be relatively minor in its total impact compared with to these other factors.

Senator **Domenici**. Would the chairman yield?

Chairman **Sasser**. Certainly.

Senator **Domenici**. Doctor, isn't it true that assuming the facts are as the chairman indicated, you would then assume that we would have much more capital available for private sector growth, modernization, and the like?

And if you are going to move scientists from the public sector to the private sector, the demand for their services is more apt to occur in an orderly manner if, in fact, we have the growth activity occurring that requires scientists and engineers. Is that true?

Dr. **Reischauer**. If we get interest rates coming down and that spurs investment, you are going to have a lot more interest in hiring engineers.

Senator **Domenici**. The only reason I asked the question, Mr. Chairman, is because it seems to me we are going to start hearing "Why doesn't the Government try to find a way to move the scientists and engineers from defense to the private sector? It appears to me that you can go through all kinds of retraining and incentives, but the most significant way to do it is to build into the private sector the capacity to adjust to the change in the world scene.

Chairman **Sasser**. Well, I don't disagree with that, and I think one of the first things we could do here in this body is to do away with these leveraged buy-outs. You know, I was shocked to read—well, not shocked because I knew it—a front-page story in the New York Times yesterday or the day before about the dramatic decline in research on the part of U.S. corporations.

And I think much of this can be attributed to this leveraged buy-out craze that we were exposed to during the decade of the 1980s. And if these corporations are forced to burn up all of their equity trying to avoid being a target, or if they have no corporate equity with which to finance research and employ these scientists, then simply putting these scientists out on a market which does not exist for their services, I agree, is not going to do much about stimulating this economy. We have got to find ways to encourage private industry to do more in the field of applied research and basic research, in my judgment.

One final question. Dr. Reischauer, the administration is taking the position that with regard to conventional arms reductions or conventional force reductions in Europe that we reduce the present 310,000 troops that we presently have stationed in Europe to carry out our NATO commitment down to about 275,000. At the same time, negotiations have continued on reducing strategic nuclear inventories on the part of each one of the superpowers by 25 to 30 percent.

Now, what would be the so-called steady state annual impact on our defense budget if our current proposals for both conventional and strategic nuclear arms negotiations were adopted; that is, if our view of reducing down to 275,000 in Europe in manpower and if the 25 to 30 percent strategic reduction were adopted, what impact is that going to have on our defense budget in a steady-state scenario?

Dr. **Reischauer**. The answer to that is that the impact will be rather modest if we do no more than is required by the treaties. If we do reach a CFE agreement with the Warsaw Pact, we will be cutting something in the neighborhood of 30,000 men, as you suggested, out of our European forces, about two-thirds of a division in the Army and one-and-a-third wings of tactical aircraft. This will, in a steady-state situation, lead to budget savings of around $3 billion.

Successful conclusion of the START treaty and a continued desire on the part of the United States to modernize its strategic arsenal, which would be permitted under this treaty, would lead to additional savings of $3 billion to $4 billion. So we would be talking about $6 billion to $7 billion steady-state savings from this. That would be, I would think, the minimal compliance. We could decide, of course, to go much further.

Chairman **Sasser**. Well, let me ask you this question. Now, this committee heard in December testimony from former Secretary of Defense Robert McNamara, and also from former Assistant Secretary of Defense for Manpower in the Reagan Pentagon, Dr. Korb, that we could reduce defense spending dramatically below what the administration was proposing.

Now, McNamara was proposing that we move back to spending levels of the 1980 period. Korb was proposing spending cuts in the outyears even below that. In 1990 dollars, McNamara was looking at spending, in 4 or 5 years, of $200 billion for defense, which has been our post-Korea, post-Vietnam defense spending average, the so-called peacetime average.

Now, if we were to take steps to adopt the so-called McNamara approach, what would be your view, then, of steady-state savings?

Dr. **Reischauer**. If we went back to 1980 force levels, we would be cutting two divisions out of the Army and one of our 24 tactical air wings and one of our carrier groups. These cuts would produce savings of somewhere between $10 billion and $20 billion in a steady state.

I might point out that both the savings I am talking about now and the ones with respect to the CFE and START treaties are not savings that could be realized in fiscal year 1991. As you know it takes a long time to implement and demobilize forces.

Chairman **Sasser**. We understand that, but you are talking about a steady-state saving of $10 billion to $12 billion there?

Dr. **Reischauer**. $20 billion.

Chairman **Sasser**. $20 billion there. Now, you are not taking into consideration in your $20 billion figure the recommendations that were made by McNamara and others that we cancel some of the new weapons systems coming on line, such as the B-2, ATF, et cetera?

Dr. **Reischauer**. No; That would certainly add to it.

Chairman **Sasser**. Those savings would be over and above that?

Dr. **Reischauer**. Yes; I am just referring to what would result if we went back to the force structure that existed in 1980.

Chairman **Sasser**. Thank you, Dr. Reischauer.

Senator Domenici.

Senator DOMENICI. Dr. Reischauer, I wonder if you would confirm this for the record for me. This will be my last effort to put in the record where I think we were in 1987 and 1988 versus Gramm-Rudman-Hollings.

My calculations would indicate that in 1987, 1988, and 1989, we cumulatively exceeded the Gramm-Rudman targets by a total of $33 billion.

We are hearing talk as if the Gramm-Rudman targets have been emasculated, and my numbers would indicate $33 billion is the total cumulative, amount, that we exceeded the targets. That would be 1987, 1988, and 1989, Gramm-Rudman targets. I would like you to just confirm that, please.

Dr. REISCHAUER. OK, I will, but remember we changed the targets, first of all, and we didn't require a tremendous amount of deficit reduction when we changed them.

Senator DOMENICI. I understand.

Dr. REISCHAUER. Moreover, in fiscal year 1989, the year just closed, as we have discussed, we missed the target by $17 billion.

Senator DOMENICI. That is right.

Dr. REISCHAUER. The previous year's deficit, if I can remember correctly, was $155 billion, and the Gramm-Rudman-Hollings target was $148 billion. So we were $7 billion off in that year. Then there is the question of what the 1987 target was, because the deficit that year came in at $150 billion and the target was changed.

Senator DOMENICI. Right, but I think the target was $144 billion.

Dr. REISCHAUER. OK. Well, then, we missed by $6 billion, so it is $6, $7, $17 billion.

Senator DOMENICI. Which equals $30 billion. I only make the point because I am trying to equate something with the words "embezzlement," "thievery," and the like, and I am trying to do that in some way that I can measure.

Dr. REISCHAUER. I think the point that you made earlier is a terribly important one, and that is that when we set the deficit targets both in 1985 and in 1987, when we reset them, we were well aware that the social security system was going to be running very large surpluses and growing surpluses, and that was certainly factored into congressional and administration decisions when they set those targets.

My guess would be that if the Social Security system at that point was perceived to be not building up surpluses or to have declining surpluses, the Congress would have accepted a very different set of targets.

Senator DOMENICI. I don't think there is any question that that is the case. The number of a $55 billion tax cut has been bantered around, and some have suggested that perhaps it ought to be offset by a 5-percent value-added tax. I wonder if you have the capability to give us a set of facts about this so-called 5-percent value-added tax.

Let me ask if you would do something for us. Exclude food and housing, and then would you tell us for the record, what the distributional effects would be if you reduced the social security payroll tax by $55 billion in its first full year. Tell us how much it would reduce the taxes on various brackets of individuals that are paying it. On that one, I don't want you to include the corporate portion of the tax, just the individual share for this one piece of paper. Then assume the value-added tax of 5 percent, with the definitional exclusion, and analyze how much those same bracketed wage earners in the country are going to pay under the 5-percent value-added tax. Would you do that, please?

Dr. REISCHAUER. Yes, I would be glad to do that.

Senator DOMENICI. I think you are going to find that they are going to pay more under a value added tax, but nonetheless we would like you to see what you think.

[The following was subsequently supplied for the record by the Congressional Budget Office:]

If the revenue lost from lowering payroll tax rates were made up by imposing a value-added tax (VAT), it would make the tax system less progressive, as shown in Figure 1.[1] The impact of levying a value-added tax of a little over 3 percent would be to increase the net taxes of the two-fifths of families with the lowest incomes by between $22 and $147. The remaining families would receive net tax reductions of between $43 and $106. The one-fifth of familes with the lowest annual incomes would face the largest net increase in taxes. Many of these households spend more than their annual income by borrowing or by selling assets, as for example would be likely among the elderly. Households in such circumstances would pay relatively little in payroll taxes, and thus would receive little or no tax relief from lowering such taxes, but they would pay value-added taxes on their purchased consumption.

These changes would increase the tax burden of the one-fifth of familes with the lowest annual incomes by 19.1 percent, while raising or lowering the tax burdens of the remaining families by small percentages. As in the case with increases in income tax rates, these changes in net taxes represent fairly small changes in the after-tax incomes of families. Unlike the income tax, they would be regressive. Families in the bottom two-fifths of the income distribution would have a decrease in after-tax incomes, while familes in the upper three-fifths of the income distribution would have an increase in after-tax incomes.

While replacing payroll taxes with a VAT would make the present tax system less progressive, let me note that these measures overstate the increase in regressivity because a portion of families with low incomes in a particular year are not needy by other standards. Some households, for example, are able to sell assets to pay for spending that exceed income. Value-added taxes would take up a larger share of the income of such households than it would of households that finance spending entirely from their annual income. In this case, value-added taxes would appear regressive, even though some families able to pay for spending out of existing wealth may not be needy.

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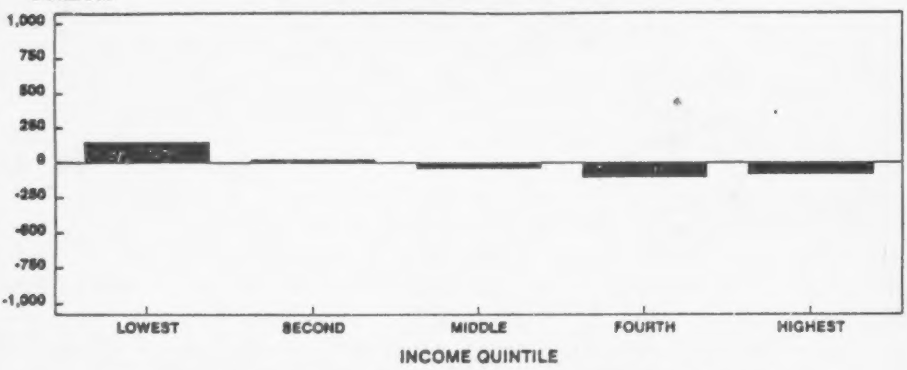
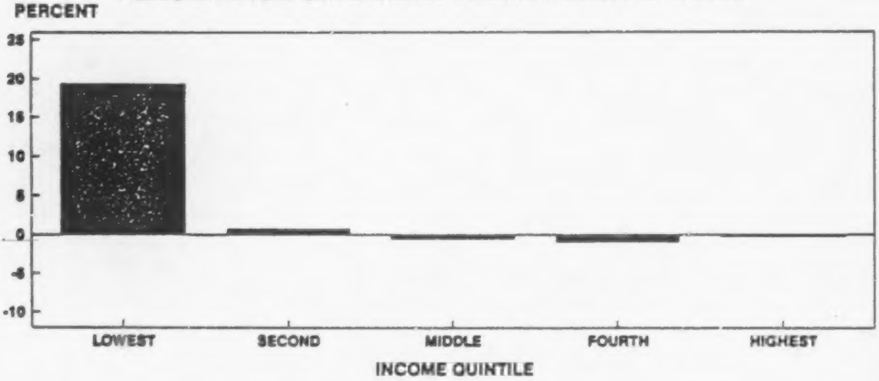
[1] The simulations are for a VAT that excludes food purchased for home consumption, housing expenditures (including utilities), medical care, edcuational expenditures, and contributions to religious and charitable organizations. This VAT is similar to that proposed by Senator Hollings as a replacement for lower payroll taxes.

FIGURE 1. S. 2016 WITH OFFSETTING VALUE-ADDED TAX

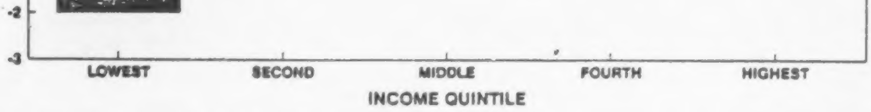
AVERAGE CHANGE IN TAXES



PERCENTAGE CHANGE IN TOTAL FEDERAL TAXES



PERCENTAGE CHANGE IN AFTER-TAX INCOME



SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

Senator DOMENICI. Mr. Chairman, you talked about scientists in the United States and scientists and engineers in Japan. I just want to suggest to you if we had some way of changing the brain drain, we ought to start with some disincentive in the United States to educate more lawyers.

I can, for the record, tell you that last year, the United States produced roughly 35,000 lawyers, up 50 percent from 10 years ago. And we produced the astronomical total of 2,000 Ph.D.'s in physics, math, and science. I think that is a pretty good scenario of what is happening to the country.

Chairman SASSER. I think it is, and if I could just agree with my colleague as a former lawyer myself——

Senator DOMENICI. Same here. [Laughter.]

Chairman SASSER. I agree with the statement, I think, made by the dean of perhaps the Harvard Law School. I don't want to ascribe this to the dean of the Harvard Law School if it is inaccurate, but the dean of one of our largest and most prestigious law schools, who indicated just a short time ago that too many of the best brains in this country were becoming involved in the practice of law.

And I agree that that is occurring, and lawyers really don't produce much except paper when they get beyond protecting the basic civil liberties and establishing the basic order in society. I think we have got too many lawyers, and, I might say to my friend from New Mexico, too many investment bankers.

Senator DOMENICI. Well, that is probably true. I am guilty of both. I used to be a lawyer. I join you as a former lawyer. I have eight children and they are doing terrible—two lawyers already and a third one over there at Stanford Law School, and I can't do anything about it. I am very hopeful they will get educated and then do something else. [Laughter.]

But in any event, I think we ought to make major improvements in the medical malpractice system. Maybe that would help slow a little bit of the growth in costs of health care.

I am going to submit a question to you on the medicare baseline growth. I would like you to answer that.[1]

I would like to confirm one other thing. We have had a rather interesting discussion about the $272 billion baseline assumption in 1985 for the deficit in 1989, in which Senator Gramm contends that we have done very well by going from a $272 billion projection to $152 billion actual. You countered by saying, yes, numerically, that looks good, but don't forget we changed the baseline in defense.

Let me tell you what I understand that to be, and would you confirm it? If you can now, fine; if not, in the record. If you do the change the baseline for defense, the $272 billion becomes $225 billion. So what we would have is a projection of a $225 billion deficit then and Gramm-Rudman-Hollings would have been successful in going from $225 billion to $152 billion. If that is correct, we will leave it stand. If you have a better number, I would appreciate having it for the record.

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[1] See p. 72.

Now, let me say to Senator Sanford, I know how interested you are in budgetary terms, and I want to suggest that it is a matter of extreme interest and importance. I am not at all sure that I understand, with reference to the macroeconomics and the future of the country, the situation to be as you describe it.

But I submit to you that at the bare minimum, it is my understanding that we have not had a blue ribbon commission of high, qualified Americans look at this whole issue since 1967 when an executive commission did put together budgetary concepts and terms and the like.

I believe, with the changing circumstances, at the minimum, it is time that we seriously consider such, and that it be serious.

I would say to you if you desire to introduce a bill causing such to come into existence, you model it in some way after what I think was a very distinguished one. As I understand it, it had people like Arthur Burns on it, is that not correct, for those who were around?

As a matter of fact, I think he was one of the most distinguished leaders talking about a unified budget, for which Lyndon Johnson gets all the blame from Republicans. Actually, it was Arthur Burns who first conceptualized the unified budget from the macroeconomic standpoint, and that came into existence thereabouts.

I would be delighted to join with you in that regard. It might very well be a good 18-year exercise by some talented people.

Senator SANFORD. We are 1 year behind the locusts; they go every 17 years. [Laughter.]

Mr. Chairman, if I may ask one more——

Chairman SASSER. Yes; I think Senator Domenici's time has expired.

Senator SANFORD. I would like to say to Senator Domenici I appreciate that very much, and I have already asked him to give me a copy of that 1967 report so I can take a look at that.

Senator DOMENICI. My last one, Mr. Chairman—I was showing you CBO's changes in the baseline deficit projections as they were impacted in the outyears by appropriations bills that exceeded the baseline.

I think it would be interesting, if nothing else, for the chairman and the committee to see where those changes came from. If you don't have it here, could you supply us with how the process got away with that? I think I know where some of them came from, but I think it would be enlightening to see.

Dr. REISCHAUER. We will be glad to do that for the record.

Senator DOMENICI. OK.

[The following table was subsequently supplied for the record by the Congressional Budget Office:]

The following table provides projections of the effects of 1990 appropriations action on outlays by budget function compared to CBO's August baseline:

[By fiscal year, in billions of dollars]

Function	1990	1991	1992	1993	1994
050	−2.5	−4.3	−4.9	−5.6	−6.2
150	−2.3	−0.3	−0.1	−.2	−.5
250	.4	1.5	1.6	1.6	1.7
270	.1	.3	.3	.3	.3

[By fiscal year, in billions of dollars]

Function	1990	1991	1992	1993	1994
300	−.3	−.2	−.2	−.2	−.2
350	−.0	−.1	−.1	−.2	−.2
370	.7	.7	.8	.9	.9
400	.3	.8	1.1	1.3	1.4
450	1.0	1.4	1.9	1.9	1.8
500	.1	.8	1.0	1.1	1.2
550	.5	1.1	1.4	1.4	1.5
570	.0	.0	.0	.0	.0
600	−.0	.2	.3	.5	.8
650	−.1	−.1	−.1	−.1	−.1
700	−.3	.2	−.0	−.0	−.0
750	.7	1.6	2.2	2.4	2.5
800	.3	.6	.8	.9	.9
Total	−1.4	4.3	6.1	6.1	5.9

Dr. **Reischauer**. Let me just give you what our August 1985 baseline was for fiscal year 1990, the current year. We had it rising to $285 billion. When you make the adjustments for defense—in other words, going to our current methodology for defense—the baseline deficit actually would have declined to $186 billion in fiscal year 1990.

So if we are at $138 billion for 1990, as we expect, then we are approximately $50 billion below where that baseline would be.

Senator **Domenici**. I was referring to 1989, doctor, not 1990, when I used that $225 billion number.

Dr. **Reischauer**. OK. The 1989 numbers would be $264 billion under the old methodology and $197 billion for the revised methodology for the baseline deficit in 1989.

Senator **Domenici**. Thank you, Mr. Chairman.

Chairman **Sasser**. Senator Sanford.

Senator **Sanford**. Let me just pursue one little piece of this questioning that I think we didn't quite complete. It is my understanding that social security being calculated in the deficit figures, or as it has been expressed, to cover up the deficit, will come to an end in 1992. Is that correct? It will no longer be used in the calculations when we project at reaching zero?

Dr. **Reischauer**. That is not my understanding.

Senator **Sanford**. Gramm-Rudman doesn't provide that social security comes off-budget for that reason?

Dr. **Reischauer**. Gramm-Rudman-Hollings took social security off-budget, but said, for the purposes of calculating whether the Nation was complying with the deficit targets, add back in the social security surplus.

Senator **Sanford**. Until 1992.

Dr. **Reischauer**. I don't think so. It is through 1993, and after 1993——

Senator **Sanford**. Well, they changed it to 1993, but it originally was 1992.

Dr. **Reischauer**. Oh, originally.

Senator **Sanford**. Well, the original Gramm-Rudman said 1992.

Dr. **Reischauer**. Originally, we were to balance the budget in 1991, so it didn't make any difference. There were no deficit targets beyond that, as right now there are no deficit targets beyond 1993.

Senator **Sanford**. Well, the point being, in 1994, where will social security be calculated?

Dr. **Reischauer**. It won't make too much difference where it is calculated if we don't have a budget target that we have to meet for a sequestration process and other forms of enforcement that will force us to comply with those targets.

Senator **Sanford**. But am I correct in understanding that the Gramm-Rudman plan is that social security will be counted until a year certain, whether it is 1992 or 1993?

Dr. **Reischauer**. Yes; but the only reason why——

Senator **Sanford**. The following year, you will be looking at deficits that don't use social security to cover.

Dr. **Reischauer**. But in those following years, there will be no deficit targets.

Senator **Sanford**. Well, let us just use 1993. I don't want to get hung up on which year it is. But in 1993, we hit zero, which we won't unless the——

Dr. **Reischauer**. Counting the social security surplus.

Senator **Sanford**. Counting social security.

Dr. **Reischauer**. Correct.

Senator **Sanford**. The following year, we won't count it. If we covered up, as we likely would, $100 billion, would it not automatically be that the baseline the next year would be increased and we would have a new deficit of $100 billion?

Dr. **Reischauer**. CBO and OMB have presented since the passage of the Balanced Budget Act an on-budget deficit that does not include social security and a line that adds the Social Security Trust Funds with the balance of the budget, and my expectation would be that that practice would continue forever.

Senator **Sanford**. We would not take it off for purposes of calculating the deficit?

Dr. **Reischauer**. There are several deficits we calculate at this point. The one that matters the most and the one people are concerned about is the one that relates to the Gramm-Rudman-Hollings targets. There will be no Gramm-Rudman-Hollings targets after 1993.

Senator **Sanford**. So what will be the deficit?

Dr. **Reischauer**. This will be a matter of presentation only.

Senator **Sanford**. What will be the deficit in 1994?

Dr. **Reischauer**. The deficit, including social security, will be $130 billion under the CBO baseline forecast.

Senator **Sanford**. To cover it up, it will still be $134 billion.

Dr. **Reischauer**. Counting all of the activity of the Federal Government, it will be $130 billion.

Senator **Sanford**. Well, let me ask you, because you seemed to pick up a minute ago that pay-as-you-go might be a proper way to handle social security, at least after 1992 or 1993, or did I misunderstand you?

Dr. **Reischauer**. You misunderstood me. I am not going to argue one way or another for pay-as-you-go versus a partially funded system, which is what we have now. I think you can make an argument on both sides of that issue.

Senator SANFORD. We call the present system pay now, pay later, which means that whatever we are paying now is not accumulating anywhere that we can get to unless we pay later to cover whatever obligations we have. What is the justification for collecting more than we need?

Dr. REISCHAUER. If the rest of the budget were balanced—in other words, if we had no deficit in the rest of the budget, and the social security surplus amounted to a surplus in total government activity, would you regard that as a situation in which there were resources being saved?

Senator SANFORD. Well, I never have seen the social security contributions as a general tax and, of course, we are using them as a general tax.

Dr. REISCHAUER. We are using them as a general tax only to the extent that if we eliminated them, we would, in fact, cut spending or increase other taxes.

Senator SANFORD. Well, we are using them as a general tax only in that we are spending them as a general tax.

Dr. REISCHAUER. But, the Social Security Trust Fund looked at in isolation is taking in more than it is spending out. It therefore has resources. It is investing those resources. It is investing those resources in a way that the General Motors pension fund or the State of California pension fund would consider one of the most prudent types of investment that could be made.

Senator SANFORD. Well, we will close on that note because we are not investing them the way General Motors invests them because they have a broad portfolio, a diversified portfolio. A minor part of it is the government, and they are in a much different position.

But, furthermore, if the president of General Motors said to his controller we are not showing very much of a profit—in fact, we are showing a loss, so go get the pension funds and put them on the bottom line—they would send him to the penitentiary. That is the reason I am inclined to say that what we are doing is somewhat fraudulent because it is so different from what GM is required to do.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Sanford.

Dr. Reischauer, in your economic predictions or forecasts you are indicating that you expect interest rates to continue to ease during 1990. Now, we have had 15 months of aggressive tightening which has forced interest rates up by more than 3 percentage points.

The Fed reversed course last June and did begin to gradually ease rates, but since then interest rates have come down by a point-and-a-half. But it now appears to me that the easing policy has been put on hold. Last week, the Wall Street Journal reported that two key Fed governors came out against easing at this time.

In light of these remarks, how can we count on the Fed to move interest rates any lower any time soon?

Dr. REISCHAUER. I would not put a great deal of stock in what certain Federal Reserve governors say their view of the situation is at one moment in time.

Chairman SASSER. Well, let us not put any stock in that.

Dr. **Reischauer**. I think this is a very complex issue, in which the Federal Reserve is looking at economic information that is coming in. It has clearly been easing, as you said, since June of 1989. The pace has not been smooth. It has eased and then held up for a little while, and then eased a little more.

The Producer Price Index and the Consumer Price Index that came out last week probably gave a number of people pause. They were a little higher than people might have hoped. There is some turbulence going on in international financial markets, which makes it difficult for the Federal Reserve to ease.

Chairman **Sasser**. Let me just interrupt you right there.

Dr. **Reischauer**. I would view this as a pause more than a reversal of course.

Chairman **Sasser**. Well, now, let me just ask you why you think that, and make this statement preliminary to that. We have got the CPI going up at its fastest level since 1980. We have got the Japanese raising their own interest rates to the point now that there is only a 2-percent differential, as I understand it, between their rates and ours.

Alan Greenspan is an authentic and bonafide inflation-fighter. Some say that he overreacts to the fear of inflation and sees inflation where there are only shadows, but certainly you would agree that he does not underreact to inflation fears.

Now, given that scenario, the fact that we may have to raise interest rates to continue to attract foreign capital in here—the Japanese are raising their rates. They are also shipping capital to Germany, in preference to the United States in some instances.

How can CBO take the position that we are going to have increasing easing of the rates? What is the justification for that?

Dr. **Reischauer**. First of all, let me point out that we have some modest easing in the first two quarters of the year, and then we have rates beginning to go up in the second half of the year. Our forecast is predicated on a view that real growth will be quite weak in the fourth quarter of 1989 and the first two quarters of 1990.

The Federal Reserve is certainly looking at the price data that you have related, and also at international financial markets. But it is also looking at the real economy, and if it sees substantial weakness in the real economy, that will be one more factor in its calculation.

Chairman **Sasser**. Well, let me ask you this. What happens to CBO's projections for economic growth, which are not very robust, to say the least, anyway, for 1991—what happens if we see an uptick in interest rates one to two points rather than further easing? What would be your scenario there?

Dr. **Reischauer**. If there is a 1- or 2-percentage-point increase in real interest rates with no change in the underlying inflation rate, that certainly would be a negative development.

Chairman **Sasser**. How large a negative, Dr. Reischauer?

Dr. **Reischauer**. I am not in a position right now to give you an estimate of that impact, but certainly it would curtail the growth that we see coming in the investment area. The investment area is one of the few sectors of our economy in 1990 that we see adding strength, and it is, of course, quite sensitive to real interest rate fluctuations.

Chairman **Sasser**. Well, you might crank up your computer over there and give us a little projection of what would happen if we had an up-tick of 1 to 2 percentage points.

Dr. **Reischauer**. We would be glad to.

[The following was subsequently supplied for the record by the Congressional Budget Office:]

A sustained increase in foreign and domestic interest rates equal to the amount by which these rates increased during January would reduce the rate of growth of real GNP by about a quarter percentage point on average from the levels that CBO projected in its January 1990 forecast for 1990 and 1991. The slowing would be concentrated in housing and in business investment, and to a lesser extent in personal consumption, especially later in the period. Net exports are only slightly affected because foreign and domestic interest rates apparently moved together during January, causing little change in pressures on exchange rates, and hence on trade flows. Inflation in consumer prices, would also be little affected, since the relatively small changes from baseline levels of resource use and the exchange rate—two important determinants of inflation—would be too small to make a significant difference.

Chairman **Sasser**. Let me tell you why I am so concerned about it, because as you know, the Japanese are now concerned about their rate of inflation, which is raging ahead at 2½ percent a year. I think foreign investors have taken up about 40 percent of the increase in our national debt since 1988, and so we are heavily reliant on this foreign capital. Would you agree to that, that we are heavily reliant on it?

Dr. **Reischauer**. Yes, I would agree.

Chairman **Sasser**. So we are heavily reliant on it, and if their rates go up, we are going to have to pump our rates up to continue to attract that capital in here, it appears to me. The Japanese are raising their rates and if they are interested in putting money in West Germany so they can exploit what they consider to be developing markets in Eastern Europe, you know, I can very well see us having to raise our rates a couple of percentage points, at least, or could see a scenario where we would have to do that to attract their capital in here to beat our indebtedness problem.

Dr. **Reischauer**. This is an example of the chickens coming home to roost. When you run large deficits and you become dependent on the rest of the world to maintain your levels of investment, then you are subject to the fluctuations of world interest rates to an unhealthy degree.

Chairman **Sasser**. All right. Dr. Reischauer, the staff may have additional questions that we will want to submit for the record, but in view of the fact that you have been sitting there for 2 hours and 45 minutes, I would say that is enough punishment for any man for one day. We appreciate very much your testimony and your appearance here today.

The committee will stand in recess.

[Whereupon, at 12:45 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO DR. REISCHAUER AND THE RESPONSES

TECHNICAL QUESTION ON THE MEDICARE BASELINE

In December, the administration issued a program instruction allowing medicare contractors (who pay medicare bills) to pay bills as fast as possible in fiscal year 1990, but not in fiscal year 1991.

Questions:

1. Will this program instruction be reflected in the CBO baseline?
2. If so, what effect will it have. How much higher will fiscal year 1990 outlays be and how much lower will fiscal year 1991 outlays be? (relative to what they would have been without the administration's instruction).
3. Could you describe why CBO is (is not) including this in their baseline?

Background: The effect of the administration's instruction will be that medicare pays more than a year's worth of bills in fiscal year 1990 and less than a year's worth in fiscal year 1991. It represents a shift in payments of perhaps $1.5 billion from fiscal year 1991 to fiscal year 1990.

Answer: The change in the medicare payment schedule is not included in our current baseline. When the baseline projections were completed in late December, insufficient information was available to assess the effect of the new policy. Even now, the Health Care Financing Administration has not sent out instructions to the medicare financial intermediaries to implement the proposed change. We will review the situation again next month, when we revise our baseline in conjunction with our annual analysis of the President's budget.

MEDICARE BASELINE GROWTH RATE

Questions:

1. What is the growth rate in medicare for fiscal year 1991 and over the 5-year period?
2. Could you comment generally on why medicare is growing so fast? How much is attributed to (1) beneficiary growth; (2) inflation in the general economy; (3) health inflation higher than general inflation; (4) increased utilization of services; and (5) other factors?
3. Other than the reduction in general inflation in the economy in the early 1980's, has anything reduced the underlying growth rate in medicare?

Answer: Medicare spending is projected to increase by about 12 percent in 1991 and at about 12 percent per year over the 5-year period.

A little over 1.5 percent per year of growth in medicare is attributable to beneficiary population growth. An additional 4 percent per year could be eliminated by freezing certain program prices. Approximately 6 percent of growth per year is due to a combination of increased quantity and complexity of services provided and the increase in uncontrollable prices.

While considerable legislation has been enacted to reduce medicare spending, program growth has not changed much. Between 1980 and 1989 medicare grew at about 12 percent per year, general inflation grew at about 5 percent per year making underlying program growth about 7 percent per year. For the 1990–95 period, we are projecting medicare to grow at about 12 percent per year and general inflation at about 4 percent per year, making underlying program growth about 8 percent per year.

VIEWS OF THE OFFICE OF MANAGEMENT AND BUDGET FOR FISCAL YEAR 1991

WEDNESDAY, JANUARY 31, 1990

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser, (chairman of the committee) presiding.

Present: Senators Sasser, Hollings, Johnston, Exon, Lautenberg, Simon, Sanford, Wirth, Conrad, Robb, Domenici, Symms, Grassley, Kasten, Nickles, Rudman, Gramm, and Bond.

Staff present: John L. Hilley, staff director; John Callahan, deputy staff director; and Alan Cohen, assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; and Cheri Reidy, economist and senior analyst.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

This morning, we want to welcome the Director of the Office of Management and Budget of the United States Government, the Honorable Richard Darman. Mr. Darman, we're pleased to have you with us and want to extend to you a warm welcome.

Mr. DARMAN. Thank you, Mr. Chairman. It's nice to be here.

Chairman SASSER. We are beginning a new budget year, and the atmosphere this year, I would say, is markedly different from last year. Last year was marked, I think, by a spirit of mutual forbearance and also marked by a spirit of cautious optimism. This is a somewhat historic budget setting here today because we're being presented with the first totally new budget of the Bush administration. The budget that we were presented last year was simply a modification to some extent of the previous Reagan budget.

I've examined the administration's budget this year for fiscal year 1991 with great interest and examined it in some detail. And, frankly, I'll say to my colleagues that it's no worse or no better than what we've become accustomed to over the past 9 years. Therein, I think, really lies the disappointment. The disappointment comes from the fact that I think it's now crystal clear to all disinterested observers that this President and the administration that you serve, Mr. Darman, with such dogged dedication is not going to lead in fiscal matters. This administration has sent a clear and unmistakable signal that it is abdicating the responsibility of leadership on the very substantial fiscal problems that are facing this government.

Indeed, you could make a case that it's even worse than that. At least last year the failure on the part of the administration to lead was substituted by an effort to act in concert with the Congress to deal with the fiscal problems facing the country. And now we see that even that tentative and weak effort has been abandoned.

I think what we have before us today in this budget document is really a relic of the past decade. I've described the 1991 budget as a menu made up of cold war leftovers and warmed-over Reagan. And with regard to the defense function in the budget, it's clear that the specter of the cold war that has ceased to haunt Europe continues to haunt the Bush budget. The bloated defense function of this budget is symbolic of the anachronistic quality that seems to permeate the whole document.

Yes, there are whiffs here and there of forward thinking, but that aroma evaporates very fast when you start looking into the salient portions of the budget itself. And like many of my colleagues, and I suspect those of you in the audience, I watched the House Budget Committee proceedings on television last night. And I was reminded of the musings of that great philosopher, Yogi Berra. Frankly, it was deja vu all over again. I could think of nothing other than a replay of the David Stockman days before the same committee, but with only a slightly different cast of characters. The hostility and the partisanship was there for all the country to see, I'm sorry to say.

But perhaps the troubling difference between the Reagan years and today is that this is an administration that I think should know better. That was very obvious, I thought, in the trenchant prologue that the Budget Director who is before us today included in the budget document.

Mr. Darman, I think you recounted with admirable precision the gravity of the fiscal situation that this government faces. Unfortunately, the prologue was not followed by an enacting clause.

Now, some have sought to present this as a forward-looking budget, and I challenge that contention for three simple reasons. First, it does not even begin to initiate a cold war defense build-down. The defense function is sustained by all the old defense policy assumptions in spite of what grizzled and battle-scarred cold war veterans as Richard Perle or James Schlesinger have said about the cold war, in essence, in Eastern Europe being over. The defense function sustains all the old programs and all the new costly weapons systems for which there doesn't appear to be a use in the decade of the 1990's and beyond. Like the B-2 bomber and like star wars, its utility is now gravely in doubt. And it's a Pentagon budget that continues to spend at the rate of some $80 billion in 1990 dollars above the peacetime average of the Ford-Nixon era. So, clearly, it's not the first step towards the peace economy.

Second, the centerpiece of the revenue component in this budget is a relic of what I would call the failed supply side experiment of the 1980's. The capital gains tax cut is no more likely to stimulate substantial economic growth than the 1981 tax cut was likely to stimulate a balanced budget.

And, finally, this is a backward-looking budget because it recognizes the problems in front of us, but then it goes on to ignore them.

So, for all of these reasons, the budget creates in my judgment a very serious leadership void. It outlines a deficit of $100 billion. The Congressional Budget Office says the deficit will be $138 billion from 1991, but I will wage with my colleagues that when we total up at the end of fiscal year 1991 the increase in the national indebtedness, we're going to find that our gross national indebtedness for fiscal year 1991 will have increased more in the nature of $350 billion.

So I would simply say that where there is a void in leadership, then the partisan strife that you warned of in your introduction, Mr. Darman, may very well rush in, and with that will come resultant gridlock, I fear.

Having said that, I'll turn now to our distinguished ranking member, Senator DeConcini—Domenici, excuse me, for his observations. Pardon that Freudian slip of the tongue, Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, "Bob." [Laughter.]

I couldn't think of any play on "Sasser."

Chairman SASSER. You came back very well, I might say.

Senator DOMENICI. I think that was good that you did that because that did add a bit of levity to a normal ritual which started off today as one might have expected. I do hope, though, that we get through the annual ritual quickly because we've got a lot of work to do.

Clearly, when you look at a budget of this size and the goals, there's an awful lot of things to talk about here today. I'd choose, however, to just make about three points.

You know, when the President has to produce a budget, he does it all by himself and it's his. Up here on the Hill, we have much more of a luxury. We in the Senate can produce at least a hundred budgets, or at least the rhetoric to support a hundred. You add the House to it, and we can produce 535 budgets.

Mr. Darman, everyone knows this is not a perfect budget. Obviously, these are very difficult fiscal times. I hear a lot about the budget for the future. I think it would be interesting to see what those who are talking about a budget of the future would do differently. And perhaps we'll have an occasion, not individually but perhaps before we're finished here, to find out what those who want a future budget and continue the claim the President's isn't.

I think we need a budget for the future, and I think we have a lot of problems in this country. I'm concerned, however, that I hear an awful lot about how we'll fix the future and make it better, but I haven't seen very many budget proposals from Members of Congress that I think would do much better than this President's budget.

Having said that, I do compliment you, Mr. Darman, and the President. Many around think that you have dramatically cut the domestic agenda program of this country on the appropriations side. If my arithmetic is right, the appropriated accounts of this country are going to go up 5.5 percent in this budget.

Now, maybe there are some who would say a future budget would have those accounts going up 25 percent. That would be interesting. We'd like to see how that would significantly help the future of this country, in particular when the primary mission of this government, as I see it, is to find ways to maintain a strong, vibrant, growing American economy. And we ought not lose sight of that.

Having said that, obviously if it's going up 5.5 percent, which is higher than inflation, one ought to be interested in knowing where you want to spend the money. And, obviously, the President doesn't want to spend the money on all the programs of the past but, indeed, has included a long litany of programs that some might call programs of the future: heavy emphasis on research and development, heavy emphasis on science, substantial increases where the Federal government is involved in education at the very lowest end for the youngest of children. So I think where you have chosen to spend more money is right on target. It happens that many want to spend it on all the old programs and new ones, also.

On defense, I'd just like to make two comments: First, I happened to attend a meeting with a number of defense experts. They reminded me of an interesting statement that Dwight Eisenhower made. Apparently it's not quite as well known as his statement about the industrial military complex, but it's interesting. He used to tell his people: "Don't hurry to make a mistake." I think that's very interesting.

Do we have a President who is truly interested in negotiating with the Soviet Union for a reduction in arms, both strategic and conventional, or not? If we do, it seems to me that he deserves at least an opportunity to do that.

Do we have allies in Europe called NATO or not? And if we do, it seems to me that this President deserves an opportunity to negotiate with them and the Soviet Union on both further conventional and strategic arms reductions.

I believe he will succeed, and I believe we will find that he will do better than currently contemplated. He can report back to us on those negotiations, and we can decide how that report fits into the current proposals of the administration.

I also am reminded that someone analyzing the situation in Europe had another interesting observation: Nothing's more dangerous than walking in a river where the ice is breaking. I think that fits also. We aren't anywhere close to knowing how this whole thing is going to work out. The free world has succeeded, and I believe this President has given us a good proposal to begin the arms reduction in a reasonable and sensible manner. He is the first President since 1971 to send a budget that is reduced in this manner, and not for 1 year but for 4 years in a row.

Having said that, Mr. Darman, fellow Senators, I do believe that the acrimony and the contentiousness of the ritual is getting more severe each year, and I hope it ends when we finish today. I'm sure we're going to have plenty of contentiousness today. But then we're going to have to get together.

Mr. Chairman, I hope you can get a budget, but I'm not at all sure we're going to get a budget unless the rhetoric gets turned down. We need to decide to produce a budget and not change the budget process here in the next 6 months, not get rid of Gramm-Rudman in the next 4 or 5 weeks, and not proceed to remove the social security reserve with traumatic tax reductions midstream. Because, I tell you, if you try to do those things plus get a budget, we'll have gridlock just as certain as New York has it perhaps once a day on their street corners.

Having said that, let me suggest, Mr. Darman, that I do believe we're serious. I do believe that you have done as much as you ought to do to remind us of the necessity of our seriousness. I also believe it might be time for Congress and the White House to consider getting together, Mr. Chairman, to produce some kind of fiscal plan beyond this budget. I favor that, and I hope we can do that. If we can't, we'll muddle through. But I don't believe we're going to do any better than the President has.

Thirty to thirty-five billion dollars in deficit reduction seems to be what everyone has in mind. We can talk all we want about how much more we'd do, but that's about what we're going to do. How we do it is important, and I think we ought to get on with trying to get it done.

Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you very much, Senator Domenici.

We'll turn now to the Budget Director, Mr. Darman, and we'd be pleased to hear your comments and observations this morning, Mr. Darman.

STATEMENT OF RICHARD G. DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DARMAN. Thank you very much, Mr. Chairman. Thank you very much, Senator Domenici.

Distinguished members of the Senate Budget Committee, it's a pleasure to appear before you to discuss the President's budget. For the convenience of the committee, I have provided each of you with a separate copy of my introduction to the President's budget, along with the budget itself, and an associated fact sheet. I ask, Mr. Chairman, that the two shorter documents be included in the record with your permission.

Chairman SASSER. They will be included in the record without objection.[1]

Mr. DARMAN. Thank you.

There is, I know, a host of questions you would wish to ask. In the interest of conserving time, I would propose simply to highlight a few points and then look forward to responding to your questions.

First, some will note, already have noted, the change in the physical structure of the budget. I would suggest that the more important change is in the intellectual structure of the budget. It gives greater attention to the future than has previously been characteristic by separately focusing on both issues of investment in the future and on the full range of contingent liabilities. It doesn't yet go as far as I would like to see it go in this direction, but it is, I think, a significant move in the way in which we not only present but ultimately think about the budget and budgeting.

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[1] See p. 83.

Second, among the areas of investment one might highlight in addition to the tax incentives, which Secretary Brady has highlighted independently, I would note these: record high Federal support for research and development, over $70 billion; record high investment in the exploration and use of space, including a $2.9 billion increase for NASA, up 24 percent; record high investment in education, $24.3 billion, and in Head Start, up half a billion dollars to its highest level ever; record high investment in the national drug control strategy, up $2.8 billion in outlays, a 41-percent increase over the level enacted just a few months; over $2 billion in new budget authority for initiatives to protect the environment; a $2.5 billion investment in modernizing the national aerospace system, that's up 45 percent; and a $2.2 billion investment in HOPE Grants as part of Secretary Kemp and the President's larger effort to bring opportunity and progress to distressed communities.

Now, this, of course, is simply an illustrative set in a budget that is over $1.23 trillion, larger than the entire West German economy. It's almost preposterous to even imagine summarizing it.

Third, for those interested in how deficit reduction is nonetheless achieved, I would point you toward the increase in revenues from continued economic growth, $83.5 billion by our estimate, and from new receipt measures which we propose, a net of $13 billion plus; the reform of mandatory programs which are discussed in section 5 of the budget beginning at page 181 and discussed in some detail; the reductions in defense to which you, Senator Domenici, and you, Senator Sasser, have already referred and about which, I'm sure, we will have occasion to talk further; the reductions in selected non-defense discretionary programs which are noted in the section that commences at page 271.

And I would note parenthetically, Mr. Chairman—and I trust that we might agree at least about this—that where last year I believe you coined the expression, "the black box," this year there is no black box. Quite the contrary, we've done our best to provide information about every significant and, indeed, many rather minor changes where spending would be either less than current services in the mandatory programs or less than last year in discretionary programs, along with a brief justification, in some cases a long justification for each.

Chairman Sasser. Well, that was a step forward, Mr. Darman, in dispensing with the black box, and for that we are grateful.

Mr. Darman. Well, thank you very much, Mr. Chairman. [Laughter.]

Senator Domenici. This is getting awful cozy.

Mr. Darman. If it can be sustained.

The fourth introductory point: As a matter of general perspective, the overall picture with respect to the deficit, it seems to me to be fair to say, is mixed. On the one hand, the pattern of continuous erosion that characterized the early and mid-1980's seems to have been broken. At worst, the deficit seems to have stabilized. By most measures, it is coming down. On the other hand, this is no time for complacency, especially in view of what I've termed the "hidden Pac-Men."

Fifth, although some are now proposing that we abandon budget discipline, we need budget discipline now more than ever. This past year, we started to use sequester seriously for the first time with across-the-board cuts. We're beginning to get the deficit under responsible control. But exactly because the discipline of sequester may be effective, some are now proposing to get rid of it. We do not believe that that would be wise, and we would not accept the repeal of sequester.

Finally, Mr. Chairman, if you would permit me, I would take just a couple of minutes to respond to a few of your introductory comments, if I might. You referred to hostility and partisanship which some may have seen on the television yesterday. You might be curious to know that there was actually less than in the same committee the previous year.

I would wish, in any case, to underline that I feel absolutely no hostility, and I do not believe we should approach this problem in any spirit of partisanship. And I look forward, if I might use your phrase, to our working in concert.

You suggested that this budget was a—I think I'm quoting correctly—"relic of the past."

Chairman **Sasser**. That's accurate, yes. That's an accurate quote.

Mr. **Darman**. And here I would respectfully differ just briefly at the start in two respects. One I've already alluded to. The intellectual structure of this budget is changing, and that is not a politically interesting point. But if we're really serious about fixing our problems, at some point we're going to have to change the structure of our budget itself, not just the budget process, because this cash budgeting system we have does not accurately focus on real problems and real opportunities affecting the future. We've made a step in that direction, which is a break from the past, and which I would hope we could work on, not in this discussion here today but over time in the future. I think it will pay substantial dividends if we can get that particular job done right.

Secondly, in suggesting that this was a relic of the past, you referred to—I don't recall the exact phrase, although I know it was memorable—the cold war, continuation of the cold war.

Chairman **Sasser**. I called it a combination of cold war leftovers and warmed-over Reagan.

Mr. **Darman**. Right. The cold war leftovers part, I take it, is a reference to defense spending, and I would just repeat the point that Senator Domenici made. Without trying to get into the defense of the defense budget at this point, assuming there will be questions on that subject later, the reality is this is a budget which proposes a 2.6-percent real cut in defense in the first year and a 2-percent per year real cut in defense for every year thereafter.

There has never been a proposal by a President over 5 years to cut in real terms every one of the 5 years. There have been periods in history when there have been such cuts, but this is the first time a President has actually proposed a 5-year plan to cut in real terms in every year. Clearly, if we were still possessed by a cold war mentality, you could not possibly justify it. It would be irresponsible to propose a budget that declines in real terms for defense.

Finally, I would note in conclusion that you referred to the "failed experiment" of the 1980's, and I suppose that may be partly what you mean by warmed-over—or at least related to warmed-over Reagan. I don't believe that this is exactly the same, or even substantially the same as previous budgets. But putting that aside, suppose you were correct. If we could be so fortunate as to continue the "failed experiment" and have 7 more consecutive years of economic growth as a result of this budget, or as a result of the process, which many lament, I think we would all be delighted. We are, as you know, now approaching the longest period of sustained economic growth in the history of the country. We are already the second longest. I don't think it is entirely fair, if I may suggest, to refer to that as a "failed experiment." But if it is a failed experiment, I hope at least the record of real growth continues.

That said, Mr. Chairman, I repeat, we do look forward to working with you constructively, and I appreciate very much the opportunity to be before you today and look forward to responding to the questions of your colleagues and your own questions. Thank you.

Chairman SASSER. Thank you very much, Mr. Director.

[The following was supplied by Mr. Darman:]

DIRECTOR'S INTRODUCTION TO THE NEW BUDGET

DIRECTOR'S INTRODUCTION TO THE NEW BUDGET

GREEN EYESHADES AND THE COOKIE MONSTER

If anything were meant for viewing through proverbial green eyeshades, it would seem to be the Federal budget. The typeface is small. The text is tedious. Tables are seemingly endless.

The sheer size of the budget makes it seem like a monster. It contains almost 190,000 accounts. At the rate of one per minute, eight hours per day, it would take over a year to reflect upon these! The budget's annual outlays are larger than all countries' economies except those of the United States, Japan, and the Soviet Union. (The Federal budget is roughly the size of the entire West German economy.) Clearly, at some point, green eyeshades must be put aside. Detail must be considered; but the capacity to abstract should not be lost.

Of course, with or without green eyeshades, monsters do not naturally invite examination. Still, if a monster is present, one might address certain threshold questions: Is it threatening or potentially helpful, and how is one to tell? The answers are not always as obvious as the questions.

On "Sesame Street," the children's educational television program, there is a wonderful character known as Cookie Monster. As all monsters are, Cookie Monster is initially intimidating. His manner is gruff. His clumsiness occasionally causes damage.

But quickly, Cookie Monster comes to be seen as benign—indeed, downright friendly. He has a few bad habits. He cannot resist gobbling up anything and everything that might be consumed—especially cookies. And he cannot quite control the way in which he spews forth crumbs. He is the quintessential consumer. Yet clearly, he means no harm.

The budget, for all its intimidating detail, might be seen similarly: as the *Ultimate Cookie Monster*. Its excessive tendencies toward consumption are not exactly ennobling. (It does not ordinarily present itself as seriously concerned with investment.) But at the same time, its underlying motivation is clearly not malevolent. What harm it may cause is largely unintended. Its massive presence might be understood as little more than a compilation of cookies received, cookies crumbled, and crumbs spewed forth.

Yet apt though the Cookie Monster perspective may be, it does not suffice. It is not quite fair to either Cookie Monster or the budget. In reality, a budget is not just a monstrous mass of cookies and crumbs. It is more: an implicit statement of values and expectations for the future. Inescapably, it is headed somewhere—or other. To gain a meaningful sense of the whole, and where it may be headed, one must look beyond green eyeshades and the Cookie Monster. One must frame the budget from several broader (and more serious) perspectives. This introduction tries to help do that.

Among the additional perspectives are these: a global historical perspective; a conventional deficit-estimating perspective; a capital budgeting perspective; a perspective that gives greater weight to future liabilities; another that attends to investment in the future; and finally, a congressional perspective. These are discussed (sequentially) below.

AND THE WALL CAME A'TUMBLIN' DOWN . . .

Looking a bit beyond Cookie Monster to the television news, one is struck with a rare impression: there may be a compelling pattern to the flow of current events. It is not represented in the budget detail by any quantitative "baseline," nor any conventional statistical measure. It was captured visually by a single dramatic symbol, beamed around the world, and etched in the mind of people everywhere: the fall of the Berlin wall.

To put the symbolic fact more clinically: State-centered, command-and-control systems seem to be decomposing. The Soviet Union has been forced to explore the virtues of restructuring, decentralization, and openness. Communist regimes in Eastern Europe have been falling like dominoes. The Iron Curtain has been opened. And the drama has not been confined to Eastern Europe. Just as liberated celebrants have cheered the opening of the Berlin wall and the decline of communist dictators, so too have liberated Panamanians celebrated the fall of the dictator in near-by Panama.

While it would be naively euphoric to consider this pattern "the end of history" (even in the limited Hegelian sense), clearly the sudden and dramatic shift toward pluralist democracy has far more than the ordinary historical significance. The events of 1989, and what they will have unleashed, may one day rise to a place with those of 1688, 1776, or 1789. This is not small stuff. It is another giant leap of the human spirit yearning to breathe free.

Yet this great historical shift has been almost trivialized in its translation into public debate about the budget. The issue has been framed as: "How big is the 'peace dividend'?"—and, in effect, "How can I get mine?" These are issues that the budget and the political system must treat. They are discussed further in the budget. But they are second-order issues at best.

Ahead of them in line, surely, ought to be these points:

- The favorable pattern of recent events has not been caused exclusively by the political and economic bankruptcy of particular state-centered regimes. It has also resulted from U.S. (and allied) military and economic strength. These, in turn, have resulted from market-oriented economic policies and sound public and private investment policies. It would be a highly unfortunate irony if—just as the world were affirming more market-oriented and investment-oriented principles—the United States were to do anything other than strengthen its commitment to these very principles.
- As the world moves away (at whatever pace) from an emphasis on the risk of traditional military superpower conflict, the relative importance of U.S. economic strength only increases. Increased economic strength is essential to inspire and to assist evolving lesser powers. And it is fundamental to success in the global competition with rising economic superpowers.
- Thus, there is a first-order issue for the budget (and the economic policy it represents): How can it best preserve and build on America's strengths, while advancing the American economy toward even greater capacities for leadership and growth? If the "dividend" metaphor must be applied to the budget: How can policy best assure that there is a continuing *growth dividend?*

HOW BIG IS THE DEFICIT?—LET ME COUNT THE WAYS

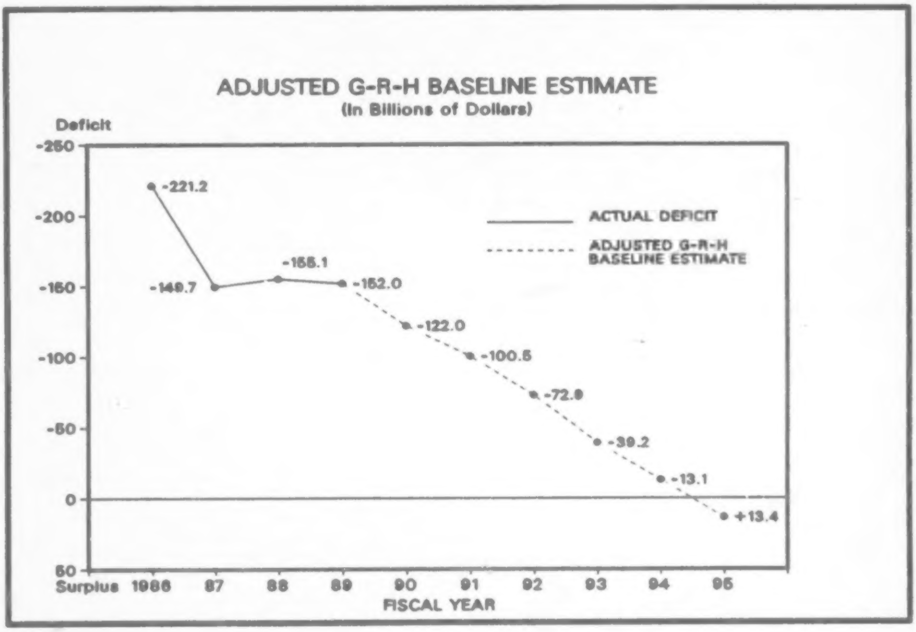
In considering this issue, many traditional analysts turn first to the size of the budget deficit. This is not necessarily as relevant a starting point as many argue. But it is relevant.

Unfortunately, a meaningful answer to the question—How big is the deficit?—is not quite as simple as the question. This budget attempts to answer the question from a wide range of relevant perspectives.

- ***The "Gramm-Rudman-Hollings (G-R-H) Baseline Deficit"***—This perspective is flawed. It biases analysis toward excessive outlay growth. But it is required by law. It constructs an estimate that uses the Administration's economic and technical assumptions; assumes entitlements grow with the beneficiary population and with prescribed benefit changes; and assumes discretionary programs grow with inflation (in effect, treating them as permanent entitlements). It assumes *no change in current law.* From this perspective, the estimated deficit for the current fiscal year (1990) is $122 billion; and for the coming budget year, 1991, it drops to $84.7 billion. It moves to surplus in fiscal year 1994.

- *"Adjusted G-R-H Baseline Deficit"*—The G-R-H baseline, an artificial construct, is used by some for reference purposes. Even for its advocates, it can be misleading. This year, for example, the Food Stamp authorization for appropriations expires. It will almost certainly be extended in some form, but G-R-H does not assume that. Conversely, the decennial census of 1990 will not be repeated in 1991. But G-R-H implicitly assumes that it will be. If one adjusts for these anomalies, the adjusted G-R-H baseline deficit for 1991-95 would be as in the chart below.

This suggests that without major legislative action—but *assuming continued economic growth*—the deficit would move toward surplus in 1995. This would mark a steady, although slow, pattern of correction from the deficit high of $221.2 billion reached in 1986.


ADJUSTED G-R-H BASELINE ESTIMATE
(In Billions of Dollars)

- *The "President's Policy Deficit"*—The President's investment-oriented proposals would help assure that the economic growth assumed in the baseline is actually achieved. Other policy proposals would further improve the rate of deficit reduction by reducing spending on low-return programs, reforming selected mandatory programs, and charging appropriate fees. These additional program savings (relative to the G-R-H baseline) are discussed further in Parts V and VII below. Their total contribution is $36.5 billion for 1991, rising to $95.8 billion for 1995.

As a result, the Administration estimates that implementation of the President's budget would meet (and slightly surpass) the legally required G-R-H deficit targets of $64 billion in 1991 and zero in 1993. The President's Policy deficit would be $63.1 billion in 1991, moving to surplus for 1993-95 (even after adjusting to assure Social Security integrity). (See table.)

Overall spending for 1991 would still *increase*—by about 3.0 percent. Almost every Department of the government would have higher budget outlays than it did the previous year. But the deficit would be reduced because estimated receipts would increase even more—by $96.8 billion or 9.0 percent (without "ducks"). *This reflects the "flexible freeze" at work:* spending growth is held at a level slightly below the inflation rate; while revenues increase at a higher rate on the strength of economic growth. This is summarized in the table, "President's Policy: Outlays, Receipts, and Deficit Improvement for 1991."

PRESIDENT'S POLICY: OUTLAYS, RECEIPTS, AND DEFICIT IMPROVEMENT FOR 1991

(In billions of dollars)

	1990	1991	Change	
			Amount	Percent
Outlays:				
Department of Defense	286.8	292.1	+5.4	+1.9%
Non-Department of Defense	910.4	941.2	+30.7	+3.4%
Total Outlays	1,197.2	1,233.3	+36.1	+3.0%
Receipts:				
Current Law	1,072.8	1,156.3	+83.5	+7.8%
New Measures	0.6	13.9	+13.3	+1.2%
Total Receipts	1,073.5	1,170.2	+96.8	+9.0%
Deficit	123.8	63.1	-60.7	-49.0%

- ***The Treatment of Social Security***—Current law defines Social Security as "off-budget", but requires its inclusion for purposes of G-R-H deficit calculations. Social Security is also included in traditional "consolidated" or "unified" deficit estimates. There are many good and important reasons to continue to include Social Security in these calculations.

  But in recent years a problem has arisen. The increasing annual Social Security operating surpluses have masked the true size of the underlying non-Social Security operating deficit. In effect, the surpluses have allowed more non-Social Security spending than might otherwise have been the case. If this were long to continue, it would result in an excessive burden of debt for future generations. It would thus undermine the effect of the build-up of reserves intended for retiring baby-boomers.

  To address this problem, without doing violence to the traditional concept of a consolidated budget, the Administration proposes to establish a "Social Security Integrity and Debt Reduction Fund." It would receive each year, as outlays, an amount equivalent to an increasing portion of the projected Social Security operating surplus (reaching 100 percent in 1996). It would be obliged to use these outlays to reduce Federal debt and thus leave a more manageable financing burden for future generations. This Fund would be linked with a continuing obligation to meet a G-R-H deficit target of zero (i.e., a permanent balanced budget) starting in 1993. Thus, the proposal *would effectively prevent the government from spending Social Security receipts on non-Social Security purposes.* The proposal is discussed further in Parts VI-A and VII-A below. Its effects on the deficit are displayed along with the other ways of looking at the deficit in the table: "Deficit/Surplus—Under Selected Definitions."

DEFICIT/SURPLUS—UNDER SELECTED DEFINITIONS

(In billions of dollars)

	1990	1991	1992	1993	1994	1995
"G-R-H Baseline Deficit/Surplus"	-122.0	-84.7	-55.5	-20.1	7.9	36.3
Adjust for outlay anomalies:						
Food Stamps	--	-16.2	-17.0	-17.7	-18.6	-19.5
Census	--	1.0	1.3	1.3	1.5	1.5
Debt service	--	-0.6	-1.7	-2.6	-3.9	-5.0
Total "Adjusted G-R-H Baseline Deficit/Surplus"	-122.0	-100.5	-72.9	-39.2	-13.1	13.4
Adjust for policy recommendations	0.6	36.5	46.9	57.5	75.6	95.8
Adjust for "Social Security Integrity and Debt Reduction Fund"	--	--	--	-14.1	-53.6	-101.8
Total "President's Policy Deficit/Surplus" excluding "gimmicks" (speed-ups)	-121.4	-64.0	-26.0	4.2	8.9	7.4
Adjust for on-off budget:						
Exclude Social Security	-62.0	-80.3	-93.1	-107.4	-124.2	-137.2
Total "On-Budget Policy Deficit/Surplus"	-183.4	-144.3	-119.1	-103.2	-115.3	-129.8
Adjust for G-R-H and speed-ups:						
Include Social Security	62.0	80.3	93.1	107.4	124.2	137.2
Include withholding and other speed-ups	--	1.0	--	--	--	--
Total "President's Policy Deficit/Surplus" including speed-ups	-121.4	-63.0	-26.0	4.2	8.9	7.4
Adjust for "Consolidated Budget":						
Include asset sales	--	1.6	1.6	1.6	1.6	1.6
Include Postal Service	-2.4	-1.7	-0.7	-0.1	0.1	0.4
Remove nondefense spendout adjustment	--	0.1	--	--	--	--
Total "Consolidated Budget Deficit/Surplus"	-123.8	-63.1	-25.1	5.7	10.7	9.4

- ***The Effect of Alternative Economic Scenarios***—In considering the deficit—by whatever definition—it is important to consider its sensitivity to economic variables. For a discussion of these sensitivities, see Section Two, Part I: "Note on Economic Assumptions and Sensitivities." The single most important variable affecting the size of the deficit is probably the real economic growth rate. As a practical matter, the net deficit-reducing effects of economic growth (or its absence) are likely to be far greater than the effects of a so-called peace dividend.

  As a general rule of thumb, a sustained one percent additional increase in real GNP growth—with all else equal—would reduce the deficit by an additional $18 billion in 1991 and an additional $98 billion in 1995. (A sustained one percent lesser increase in real GNP growth—all else equal—would have roughly the equivalent numerical effect, but with the sign changed.) For those seriously interested in either achieving greater deficit reduction or freeing up resources for greater spending, this underlines the importance of pursuing policies likely to maximize the *growth dividend.*

  The economic assumptions used by the Administration are toward the optimistic end of the credible range. But the Administration's assumptions are plausible and achievable.

  The Administration first presented its own economic assumptions in July 1989—at which point they were also judged to be at the optimistic end of the credible range. Intervening performance has, in fact, been highly consistent with the Administration's forecast. But that does not mean either that macroeconomic science has improved substantially, or that the Administration will always be so fortunate as to be correct.

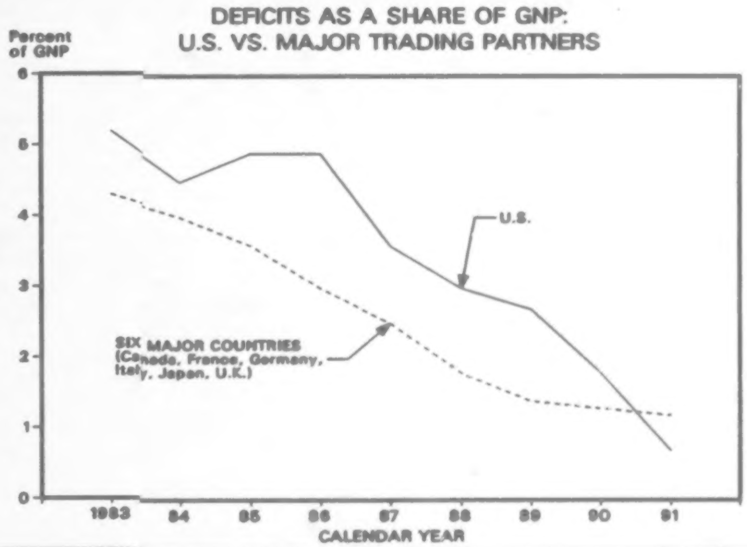
  In developing the budget, the Administration formally considered several alternative economic scenarios. Two of these are discussed in the "Note" in Section Two, Part I. Both of these are also plausible. One is slightly more optimistic, and one more pessimistic, than the scenario actually adopted. These alternative scenarios are specifically described in the Note. If the President's Policy deficit were presented with either the higher growth or the lower growth assumptions, the deficit (or surplus) would appear as follows (after adjusting to assure Social Security integrity).

DEFICIT (–)/SURPLUS (+) UNDER ALTERNATIVE ASSUMPTIONS

(In billions of dollars)

	1991	1992	1993	1994	1995
Higher growth scenario	-54.6	-16.9	+15.1	+24.7	+31.6
Lower growth scenario	-77.5	-48.4	-27.2	-32.9	-42.4

- ***Deficits as a Share of GNP***—Meeting the G-R-H deficit target for 1991, as proposed by the President, would reduce the consolidated deficit to about 1 percent of GNP. The deficit would thus fall clearly within the "normal" range for most of America's major trading partners. In any case, it would mark a significant improvement from the 5.2 percent level of 1983 (6.3 percent for the fiscal year). The pattern is suggested by the chart, "Deficits as a Share of GNP: U.S. *vs.* Major Trading Partners." While the trend is favorable, however, it should not be given excessive weight. The United Kingdom and Japan are both running surpluses—but with very different real growth rates. *As with all measures of the deficit, it is necessary to get beyond this somewhat superficial measure, to an examination of the underlying economic policies and their relation to the future.*


DEFICITS AS A SHARE OF GNP:
U.S. VS. MAJOR TRADING PARTNERS

- ***Deficit Effects of Capital Budgets***—The current budget concept—essentially a "cash" budget—was developed to conform with the President's Commission on Budget Concepts (1967). The "cash" perspective is especially useful for determining needs for financing in the public debt market. Indeed, it is essential. That is why, regardless of whether trust funds are treated as "on" or "off" budget, there must be some consolidated accounting that shows the total governmental cash position. *But if one is seriously interested in the effects of budget policy on the future, one must get beyond the cash budget frame of reference represented by the G-R-H and consolidated deficit calculations.* One needs a better sense of future liabilities and of the extent to which current income and borrowing are financing investment for the future (as opposed to current consumption and transfers).

  With this perspective in view, many have criticized the Federal Government's "cash" budget. Some have argued that the Federal Government should adopt one form or another of capital budget and/or a budget that better distinguishes between trust funds, governmental operating needs, and activities conducted by Government-sponsored enterprises.

In order to begin to address this thoroughly appropriate interest in getting beyond cash budgeting, the President's budget is re-configured as it might appear under the conceptual approach suggested by the General Accounting Office and the approach used by the state of California. These approaches are strictly illustrative—and are presented in Section Two, Part II: "Note on Alternate Approaches to Budget Presentation." They are not intended—now, or in the future—to displace the cash budget; but rather, they are intended to supplement it.

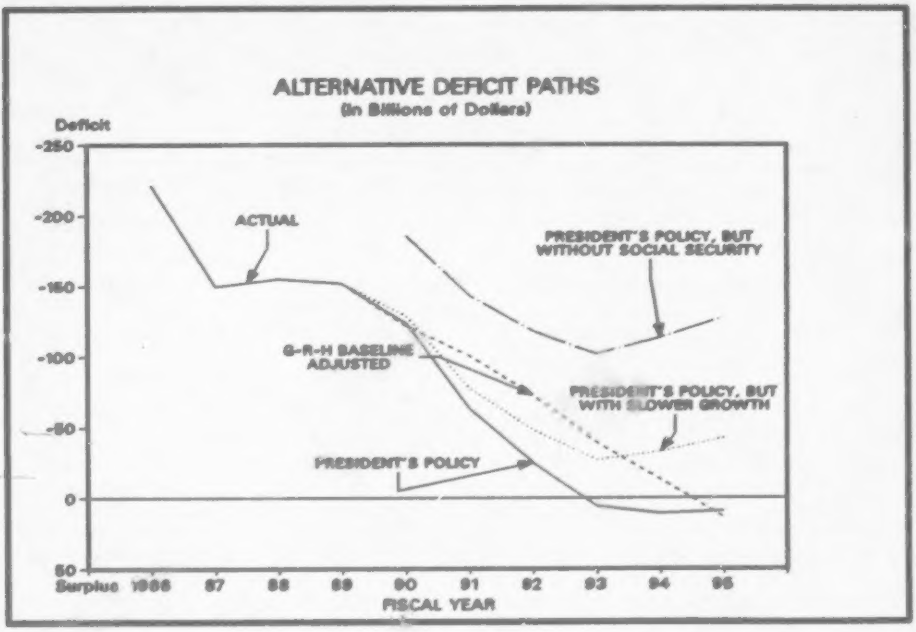
While these additional perspectives are useful, it is clear that they, too, are not fully satisfactory. In going only as far as they do, they tend to do little more than confirm what is now generally accepted wisdom: that the Federal Government invests a relatively small percent of its annual expenditures in capital; and that there is a sharp dichotomy between the operating surpluses in certain trust funds and the operating deficits that characterize the rest of government. They necessarily suggest, but do not satisfactorily settle, many difficult issues of definition as to what is and is not investment. They do not adequately treat "intellectual capital" and "human capital," for example. And they do not provide a dynamic picture of expected future liabilities and future returns.

Stepping back from this surfeit of deficits—all differently conceived and defined—one might summarize where the collection of different deficit pictures suggests things may be, and where they may be headed.

- *First,* by several different deficit measures, *the consolidated Federal deficit seems, at worst, to have stabilized.* If the President's policies were adopted, this pattern of stabilization would obtain, in the near term, even if Social Security were excluded from deficit calculation. *The pattern of continuous erosion that characterized the early- and mid-1980s seems to have been broken.* By many measures, the deficit is headed toward improvement—*assuming that economic growth continues.* Although further progress is not guaranteed. the change in the underlying pattern must be viewed as welcome. See chart: "Alternative Deficit Paths."

  The proviso concerning the necessity for continued economic growth is fundamental, however. The economy is in its eighth consecutive year of growth. This is the second-longest period of continuous growth in America's history. (Post-War Japan has enjoyed two longer periods of growth: one of 20 years, 1953-73 and one of 15 years, 1975 to the present.) There is reason to suggest that the traditional notion of the inevitability of a tight business cycle may be overtaken. But, to underline the obvious: Growth is not automatic. It depends on growth-oriented policies being pursued not only by the Administration, but also by Congress and the Federal Reserve.

- *But second, stabilization of the underlying deficit should not lead to complacency.* Complacency would lead to a loss of fiscal discipline. And even with stabilization, deficits mean rising debt. America's recorded Federal debt is already approaching three trillion dollars. (See Parts III-A and VI-A.) That is not necessarily bad per se. It depends on whether or not the debt is being used in conjunction with policies that will increase future productivity, growth, and capacities for debt service—and whether future hidden liabilities are being kept within reasonable bounds. Here, unfortunately, is where conventional Federal deficit accounting and budget presentation have been woefully inadequate. And here is where there is legitimate cause for concern—as is discussed further below.



HIDDEN PACMEN

The problem with relying solely on the consolidated cash budget—or even on that plus a capital budget—is that it does not give a full picture of the Federal "balance sheet." There is a host of technical reasons why it is not now possible to present a complete and valid Federal balance sheet—not to mention a valid projection of the future balance sheet. But it is possible to do a better job of highlighting potential liabilities, as well as important areas of investment, which have significant future effects. This budget presentation attempts to move in that direction.

One curious thing about future Federal liabilities is that many of them are not yet fully visible. Their particular nature varies. But each is like a hidden PACMAN, waiting to spring forward and consume another line of resource dots in the budget maze. These hidden PACMEN are discussed in some detail in Parts VI-A and VI-B below. A few introductory points may help outline the problem:

- ***Rising Costs of Health Care***—A quarter of a century ago, health care expenditures consumed about 6 percent of America's GNP. Now, that share has almost doubled, to 12 percent. Within the growing Federal budget, the share has risen even more rapidly, from less than 5 percent in 1970 to a projected 15 percent in the early 1990s. Obviously, this is a trend that cannot be sustained forever—or health care costs would drive out all else. There are, nonetheless, increasing demands to assure health insurance coverage for those not now covered, and to provide better financing for long term care. Each of these could entail an additional multi-billion dollar annual bill. Yet the projected health expenditure obligations of current law are not fully covered by projected future receipts. The estimated present value of unfunded liabilities (the actuarial deficiency) for Medicare hospital insurance alone could be over *$250 billion*. (See Parts V and VI-A.)

- ***Rising Budgetary Claims of Mandatory Programs***—In President Kennedy's Administration, transfer payments to individuals comprised about a quarter of the Federal budget. Now they consume almost half. So-called "mandatory" programs—selected payments to individuals (entitlements) and other automatic spending programs—have grown from 34 percent of the budget in 1970 to roughly half the 1991 budget—and will reach a projected 57 percent for 1995. (Mandatory programs plus net interest expenditures account for almost 62 percent of the budget.) Since these programs generally have broad-based and well-represented beneficiary populations, they tend to have a powerful claim on resources, and grow faster than the economy as a whole. Yet again: It would seem obvious that this pattern of more rapid growth cannot be extended indefinitely. (See Part V.)

- ***Unfunded Retirement Program Liabilities***—There is much talk about the projected build-up of Social Security reserves to cover the anticipated obligations to the baby-boom generation when it reaches retirement. The medium term build-up intended by (and projected under) current law is, indeed, enormous. But even so, over the long term, under some assumptions, the present value of current-law obligations minus projected receipts could be a negative number. This is a speculative matter with a high degree of uncertainty. (See Part VI-A.) Somewhat less speculatively, there are clearly identifiable major shortfalls in unfunded Federal employee retirement programs—although these should be able to be serviced by future contributions. And the Railroad Retirement System, although not fully a Federal responsibility, is substantially underfunded—with a reported actuarial deficiency of *$14 billion*.

- ***Obligations to Clean Up Federal Facilities***—For a variety of reasons, the Federal Government historically has not been prompt in attending to environmental clean-up at many of its facilities. For reasons of both law and policy, the pattern of the past is now changing. But the bills are yet to be fully paid. The present-value cost of already-identified future clean-up obligations and waste management improvements at Federal facilities over the next 30 years is on the order of *$140-200 billion*. (See Part VI-C.)

- ***Contingent Risks of Federal Credit Programs and Government-sponsored Enterprises (GSEs)***—The Federal Government's direct and indirect credit subsidies are far more extensive than is commonly appreciated. In housing, over a trillion dollars in outstanding mortgages have been guaranteed by Federal agencies or securitized by GSEs. In agriculture, the Farmers Home Administration has accounted for 15 percent of all farm debt outstanding, and the Farm Credit System has financed another 26 percent—for a combined total of about $55 billion. In education, nearly all student loans are Federally guaranteed. The government helps provide credit for export finance, rural utilities, small businesses, and minority-owned businesses. The purposes of all this credit support are generally worthy. But there can be no denying that there is an enormous and increasing Federal exposure—approaching one trillion dollars in direct and federally guaranteed loans alone. This necessarily involves a risk of substantial future claims against the government. These claims are virtually certain to be in the *tens of billions of dollars*. Without continued economic growth, and the credit reforms proposed by the President, the claims would be substantially higher. (See Part VI-B.)

- ***Contingent Risks of Federal Insurance Programs***—The Federal Government funds programs that directly insure individuals and firms against many hazards not covered by private insurance. These formal insurance programs cover bank deposits, pensions, veterans life insurance, crops, floods, overseas private investment, nuclear risks, and war risks. The total face value of this insurance coverage (excluding Medicare) exceeds four trillion dollars. Deposit insurance accounts for about 70 percent of this total. But the remainder is still over one *trillion* dollars. Clearly, the Federal Government is not at risk for the entire face value of the insurance. But again: The likely future claims are virtually certain to be in the *tens of billions of dollars*. (See Part VI-B.)

When one adds up all these likely future claims—unfunded health and retirement programs, environmental clean-up obligations, credit risks, and insurance risks—one can produce a rather intimidating total. (See especially Parts VI-A and VI-B.) But it is important to put this, too, in perspective. The claims do not come due all at once. Indeed, they come due over an extended period of time. If one assumed that the likely range of unfunded claims were spread smoothly over the extensive time period in which they are to come due, one would reduce the total to a much less intimidating—indeed, a *manageable*—level.

This is not to say that there is not a built-in shortfall. There is. (See Part VI.) *It is to say, rather, that the "amortized" annual amount of the projected shortfall may be on the order of one-half to one percent of GNP—assuming the problem is managed on an orderly basis.*

Over the long term, there are five ways this shortfall could be handled:

- by reducing the growth of future obligations—through "mandatory" program reforms, credit reforms, and insurance reforms (these are discussed in Parts V, VI-A, and VI-B below);
- by reducing spending on other Federal programs where returns on investment are judged to be of lower relative value (these are discussed in Part VII-B-1 below);
- by increasing the government's managerial integrity and efficiency (this is discussed in Part VII below);
- by pursuing growth-oriented economic and budgetary policies—investing in the future—so that future economic productivity and Federal receipts are higher than otherwise projected (this is the principal area of emphasis in Section One, the Overview, and is discussed especially in Part III below); or
- by increasing the relative burden of debt and/or new taxes (these latter approaches are not a part of the President's program).

INVESTING IN THE FUTURE

As noted, "Investing in the Future" is a theme given special emphasis in the Budget Overview. It was first introduced to the presentation of the budget by the President, last year, in *Building a Better America*.

The emphasis is consistent with three fundamental points: First, a budget must be viewed as more than a static snapshot; it necessarily influences the future, and the nature of that influence must be examined. Second, there is a generally accepted moral obligation to try to leave future generations in a better position than their predecessors. Third, the obligations for future expenditures and debt service are more manageable insofar as current expenditures and tax policy contribute to increased growth. Together, these three points argue compellingly for attention to the extent to which a budget (and its associated economic policy) encourage *investment*—investment in the future.

The President's budget encourages investment in a host of ways that are discussed in greater detail in the Overview. These are outlined here—with references to appropriate Parts of the Overview noted parenthetically:

- ***Deficit reduction***—By reducing the deficit, meeting the G-R-H targets, and then buying down debt, the President's budget policy would improve the U.S. savings rate and reduce the cost of capital. (This is discussed further in Part III-A below.)
- ***Incentives for Private Savings and Long-term Investment***—The President's program would improve the incentives for saving and investment through *Individual Retirement Accounts* (IRAs); create a new all-purpose savings incentive through *Family Savings Accounts*; and encourage growth-oriented, job-creating investment through a new long-term *capital gains incentive*. (These are discussed further in Part III-A below.)

- ***Research and Development***—The President's budget funds initiatives to expand human frontiers in space—NASA would grow 24 percent over 1990 to a record $15.2 billion—and in biotechnology; to advance the development of the superconductive supercollider and to increase investment across the full range of basic research ($12.3 billion—up almost $1 billion); to advance applied research in areas as diverse as defense and health, agriculture and high speed rail transportation, semiconductor development and materials processing. The President also proposes to enact and extend major tax incentives to encourage greater investment in R&D by the private sector. Total proposed governmental expenditures for R&D would exceed $70 billion. (These are discussed in Parts III-B and III-C below.) In the design and implementation of Government programs, the President's budget also recognizes and encourages the innovative role of "States as Laboratories" (discussed in Part IV below).
- ***Investment in Human Capital***—Although Federal money is not the key to solving the nation's serious education problems, the President does propose to increase the discretionary budget authority of the Department of Education by $1.2 billion—bringing the Departmental total to a record $24.6 billion. Program increases are principally in areas of investment that are consistent with the Federal Government's role and responsibilities—reflecting the basic understanding that true solutions must depend heavily on states, localities, parents, and a system that promotes greater innovation, flexibility, and accountability. The budget re-proposes the President's child care initiative—on which the Congress failed to act last year. And the President proposes not only to reauthorize Head Start, but to increase it by half a billion dollars in a single year—bringing Head Start to an unprecedented $1.9 billion. (These and other investments in human capital are discussed in Part III-D below.)
- ***Drug Control Strategy***—Clearly, it makes little sense to invest in human capital only to have drug abuse undermine that investment and, indeed, destroy the very social fabric that makes human growth and investment worthwhile. Drug abuse negates investment. It is fundamentally destructive. It must be stopped. Like education, drug abuse is a problem that cannot be solved by Federal funds alone—or by funds alone whatever their source. Nonetheless, the 1991 budget proposes $10.6 billion in budget authority and $9.7 billion in outlays to combat drug abuse. These levels represent increases of 12 percent in budget authority and $2.8 billion (41 percent) in outlays relative to 1990. They are necessary to advance the next stage of the comprehensive National Drug Control Strategy (and are discussed further in the Strategy, which is published separately, and in Part III-E below).
- ***HOPE and Enterprise Zones***—The problems of economically distressed areas will be alleviated some by the job-creating effects of continued economic growth. The problems will be mitigated also by the President's anti-drug abuse strategy. But more needs to be done to bring hope and opportunity to severely distressed areas. Thus, the President is re-proposing his initiative to stimulate growth through the creation of special incentives for investment and job creation in *Enterprise Zones*—a proposal on which the Congress has failed to act. And he is introducing legislation to advance project HOPE—Homeownership and Opportunity for People Everywhere. (These proposals are discussed further in Part III-H below.)
- ***Transportation Infrastructure***—Improving the U.S. transportation system is essential to economic efficiency and growth. It is a shared responsibility involving the private sector, Federal, state, and local government. The Federal contribution is substantial. For example, the President proposes a record $8.6 billion for aviation in 1991 to help keep the U.S. commercial aviation system the best in the world. Of this, $2.5 billion—an increase of 45 percent—is proposed to modernize the FAA's air traffic control system. (These and related transportation issues are discussed in Part III-G below.)

- ***Environmental Protection***—The emphasis on the importance of economic growth must, of course, be accompanied by a responsible concern for the protection and preservation of the environment. The President proposes over $2 billion in new spending to fund: "America the Beautiful," a new program to improve the stewardship of public lands and natural resources, and to promote reforestation; a major increase in the U.S. Global Change Research Program; an acceleration of hazardous waste clean-up; and a 12 percent increase in the EPA operating budget. (These are discussed in Part III–F below.)
- ***The American Heritage***—To the extent that investment tends to emphasize rapid technological advance, there is need for a complementary emphasis on aesthetic values, history, and the traditional cultural values that have made America uniquely strong. Although the Federal role in this area must be limited—for important reasons of pluralistic philosophy—it must not be overlooked. America's progress in the future will be the greater for building on its diverse cultural strengths. Thus programs to foster and preserve the American Heritage are treated as themselves an issue of investment. (These are discussed in Part III–J below.)
- ***National Security***—None of the foregoing would be worth very much if the budget failed to provide for the protection of U.S. national security. Though responsible analysts may differ about the best means of protecting it, national security holds a fundamental claim on governmental investment. Without adequate investment in national security, ultimately, all that America holds dear could be lost. There is, further, an obligation that America has long championed: the advancement of pluralistic, market-oriented democracy throughout the world. These fundamental interests and obligations are dependent upon U.S. economic growth. But they are also, in some respects, preconditional to it. (They are discussed in Part III–I below.)
- ***Management Oversight***—Federal investments in the future will only achieve their objectives if they are effectively managed. Improved returns on investment require a better budget process and more effective management oversight. Americans are entitled to greater assurance that their tax dollars are being invested wisely and managed with efficiency and integrity. Proposals to manage America's government better are discussed in Part VII below.

WONDERLAND REVISITED—THE CURRENT CONGRESSIONAL PATH

In the presentation of the first Bush Administration budget, a critique of "Wonderland" budgeting was offered. It focused on the curious Washington habit (indeed, legal requirement) of "current services baseline" budgeting. Under this system, a "cut" may really be an increase; and a deficit said to be going "down" may really be going up. With "current services'" built-in bias toward increasing expenditures, it should be little wonder that the system has failed to bring the deficit under satisfactory control.

In the Mid-session Review of the Budget, OMB introduced a new budget projection: the "Current Congressional Path." This was done in order to underline what some might think an obvious point. That is, the deficit is not determined, in the end, by either "current services" projections or by mathematical extensions of a "President's Policy." Forecasts based on such projections are almost always bound to be wrong. Budgets are legislated. Congressional action (or inaction) is, therefore, a fundamental determinant of actual deficits. In trying to forecast realistically, it is important to have some sense of the "Current Congressional Path."

Unfortunately, however, the Current Congressional Path is not entirely clear. Indeed, Wonderland seems to be running wild with attractive fantasies, but without yet having established coherent direction. One might consider, for example, the two big games now in play—and a third that is soon to be:

- ***The Spend-the-Peace-Dividend-Game***—This is a new game, premised on the assumption of a substantial, near-term "peace dividend." It starts by over-estimating the dividend. Then each player plans to spend the dividend in his or her preferred way. The sum of all such planned expenditures totals about ten times the over-estimated dividend, which is itself perhaps five times the actual dividend. Thus, Washington entertains the notion of spending fifty times a dividend that has not yet definitively materialized—a true Wonderland phenomenon.

In reality, the *near-term* peace dividend is likely to be smaller than is commonly assumed for three reasons: First, the true cost of the previously planned and Congressionally-approved defense program is substantially higher than the current DoD funding levels (and higher than "current services"). Much of the dividend will have to be used just to adjust the previous program downward toward current levels. Second, this adjustment—while politically popular in the abstract—will not be politically popular in all its particulars. Third, any tendency to cut further would likely focus on reducing U.S. troop strength abroad at a more rapid rate than proposed by the President—a more rapid rate than consistent with preserving a strong alliance and negotiating equitable and enforceable agreements with the Soviet Union. Presumably, these countervailing interests will be better appreciated as the debate about the "peace dividend" unfolds.

- ***The Cut-Social-Security Game***—This is ordinarily a very dangerous game politically. But in its most recent form, it has started with a superficially attractive proposal: to cut Social Security taxes. Clearly, that would be desirable if it could be done without significant cost to the people paying the taxes and to the economy as a whole. Unfortunately, the most recent proposal to attract significant attention fails that test.

  It is ironic in three respects. First, some of its advocates have argued, until recently, that the government was under-financed (and under-taxed) *not over*-financed. Yet few, in fact, can seriously argue that the government as a whole is over-financed. Second, the emerging conventional wisdom had been that one needed to do more to protect the capacity to pay future Social Security benefits, *not less*. Cutting Social Security taxes now would mean giving up on that objective—giving up on the bipartisan commitment to build up reserves for the future retirement needs of the baby boom generation. Third, and perhaps most telling: Cutting Social Security taxes now would likely hurt the very people it is ostensibly intended to benefit, today's workers. It would either force an increase in their non-Social Security taxes (to compensate for the enormous revenue loss—$55 billion in 1991 alone); or it would force a reduction in their future retirement benefits. (See Part VI–A.)

  The President's proposal to establish a "Social Security Integrity and Debt Reduction Fund" is a responsible way to protect the future interests of today's workers. But Social Security is a notoriously volatile subject when it enters the political domain; and whether rationality will prevail remains to be determined.

- ***The Beat-the-Budget Game***—This is the game that begins with the reaction to the President's budget. It has become an annual ritual. At the start, it is predictably partisan. Priorities are judged to be incorrect. Economic assumptions are ridiculed (but later adopted). Gimmicks are scorned (but later outdone). The failure of the budget process is lamented (but ideas for evasion proliferate). The refusal to raise "new taxes" is condemned (as proposals to cut taxes are advanced). Incentives for savings and investment are criticized for their alleged adverse effects on the deficit (as alternative proposals to increase the deficit are advocated). Stalemates are followed by "heroic compromises" that earn the parties self-congratulation, but somehow manage to leave much of the serious job to the future. And the public, understandably, grows more skeptical.

It may be apt to view all this metaphorically as a set of children's games: the Budget as Cookie Monster; its future threatened by hidden PACMEN; its path a journey through Wonderland. But at some point, it is appropriate to put games aside—at least for a while. ***At some point, there is an obligation to be serious.*** At some point, partisan posturing must yield to the responsibility to govern.

Sooner or later, the American political system will rise to the responsibility to be serious: to complete the job of fiscal policy correction. It may do this in small steps or large. It cannot do it with side-steps.

This year's budget meets the responsibility to be serious. It is seriously presented—giving a more complete and balanced perspective on both the present and the future than has previously been characteristic. Its emphasis on investment and growth-oriented policies and its realistic attention to long-term liabilities should be welcome. Its economic assumptions are not outside the credible range. It meets the Gramm-Rudman-Hollings deficit targets with specific and defensible deficit-reduction measures—and without gimmicks. It seeks to preserve a meaningful consolidated budget, while tightening the budget process. If implemented, it would reach balance in 1993 (as required by law), and would thereafter begin the process of reducing Federal debt.

This, of course, is not to assert that the budget will be treated seriously in the very next round of the Beat-the-Budget game. It is simply to suggest that it should be.

Richard G. Darman
Director,
Office of Management and Budget

Note: This budget is presented in a new, comprehensive, single-volume form. There is no formal record of the number of individuals who may have read, cover-to-cover, the previous seven-volume editions of the budget. (Nor are there epidemiological studies of their fate.) This new single-volume form is provided with the hope that it may be more convenient for the reader; and with the belief that it may actually provide more, not less, useful information. If any reader finds important information to have been dropped, OMB will try to remedy that unintended effect.

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release **January 29, 1990**

PRESIDENT BUSH'S 1991 BUDGET

FACT SHEET

The President submitted the *Budget of the United States Government, Fiscal Year 1991* to Congress today. The following is a summary of selected highlights. Parenthetical notes refer to pages in the *Budget* at which further discussion and detail are provided.

The President's budget meets the legally required G-R-H deficit targets of $64 billion for fiscal year 1991 and zero for fiscal year 1993.

The FY 1991 budget is presented in relation to five themes:

I. Investing in the Future
II. Advancing States as Laboratories
III. Reforming Mandatory Programs
IV. Acknowledging Inherited Claims
V. Managing for Integrity and Efficiency

I. INVESTING IN THE FUTURE (page 23)

A. INCREASING SAVING, INVESTMENT, AND PRODUCTIVITY (page 25)

1. *Balance the Federal budget by 1993,* as required by the G-R-H law. This should increase saving and investment and reduce the need for U.S. foreign borrowing. (pages 3, 46)
2. *Protect Social Security integrity and reduce the national debt after 1993.* The Administration is proposing legislation to assure that the intended build-up in Social Security reserves is *not* used to mask the non-Social Security deficit. This would have several favorable effects: national saving and investment should rise; real interest rates should be lower; and U.S. competitiveness should be strengthened. (pages 10, 46, 267)
3. *Reduce tax rates on capital gains* for long-term investments by providing a permanent, sliding scale exclusion. This proposal promotes long-term investment to increase economic growth; helps U.S. business compete in an increasingly competitive global environment; produces increased receipts for the Treasury; and, most importantly, increases jobs and the quality of life for all Americans. (pages 17, 47, A–51)
4. *Create Family Savings Accounts and Modify IRAs.* The Family Savings Account (FSA) is proposed by the Administration to give individuals and families an

extra incentive to save for the future. The proposal would exempt from income tax the interest income on certain nondeductible contributions to FSAs that are held for seven years. In addition, the Administration proposes to modify current individual retirement account rules to allow a waiver of the 10 percent excise tax penalty for early withdrawals of up to $10,000 if the withdrawn funds are used for first-time home purchases. (pages 17, 47, A–51)

B. EXPANDING THE HUMAN FRONTIER—SPACE AND BIOTECHNOLOGY, AND THE SUPERCONDUCTING SUPER COLLIDER (page 49)

SPACE

The 1991 budget proposes to allocate a record $15.8 billion in budget authority for space activities, including $15.2 billion for NASA. The NASA budget will increase by $2.9 billion, or 24 percent. (page 49)

1. *Building Space Transportation Infrastructure:* The budget proposes funding for Space Shuttle production and operations of $4.2 billion, an increase of $752 million, or 22 percent, over 1990. This will support the 10 shuttle flights planned for 1991, one more than planned for 1990, plus the continued acquisition of long-lead time spare parts, support for shuttle payloads and shuttle improvements such as the advanced solid rocket motor. (page 52)

2. *Expanding the Space Frontier through Manned Exploration:* (page 53)

   - *Space Station Freedom:* For 1991, the budget proposes a total of $2.6 billion in budget authority for the continued development of Space Station Freedom. This is an increase of $699 million or 36 percent above 1990. It will provide for the critical transition from design to actual fabrication of the first long-lead time hardware elements.

   - *The mission back to the Moon and to Mars:* The President has lifted the sights of the space program with his call for the establishment of a manned presence on the moon and a manned mission to Mars. The budget reflects the Administration's commitment to this mission by proposing $1.27 billion in budget authority, an increase of $408 million, or 47 percent above 1990 levels, for space exploration activities.

3. *Using Space to Increase Scientific Understanding:* The budget proposes to increase funding for space science missions for planetary exploration, astronomy and Earth observations over the next decade by $593 million in budget authority or 22 percent, over 1990 levels. The budget will also allow for the continuation of the development of important projects such as the Advanced X-ray Astrophysics Facility, planned for launch in 1995, and the Comet Rendezvous/Asteroid Flyby and Cassini mission to Saturn. The budget will provide support for thousands of researchers and students to acquire and analyze data from previously launched missions. (page 56)

   - *Understanding and observing global change:* The budget proposes over $1 billion in budget authority to extend U.S. leadership in understanding global environmental change. This represents a 57 percent increase over 1990. NASA is a major participant in the U.S. Global Change Research Program (USGCRP) through its Mission to Planet Earth. NASA will develop and launch a number of satellites and instruments, including TOPEX (to analyze surface ocean circulation) and the Upper Atmosphere Research Satellite (UARS) (to analyze the chemistry of the upper atmosphere.) The 1991 budget proposes a major new program, the Earth Observing System (EOS) which is a series of space-based instruments and platforms, developed by the U.S., the Europeans and the Japanese.

4. *Developing the Commercial Potential of Space:* The 1991 budget will continue the Administration's strong support for the commercialization of space. NASA will allocate $229 million in budget authority to continue to procure all of its expendable launch vehicle services from private launch service providers. In addition, the budget will provide $101 million for NASA's Office of Commercial Programs, including new funding for a special initiative through its Centers for the Commercial Development of Space (CCDS) to provide flight opportunities for innovative experiments in microgravity. (page 58)

5. *Other Space Activities:* The 1991 budget proposes $258 million in budget authority for the Department of Commerce space satellite programs. This includes $174 million for the development and launch of replacement satellites for the polar-orbiting and geostationary weather satellite systems and $47 million to operate those systems; and $37 million for the launch of Landsat 6. (page 58)

BIOTECHNOLOGY (page 59)

Advances in biotechnology can help improve the availability and quality of the food supply; prevent, identify, and cure disease; and reduce the hazards of industrial waste.

The budget proposes $3.6 billion in budget authority, an increase of $213 million over 1990, for biotechnology research and development.

To spur biotechnology R&D, the budget supports *speeding up regulatory review* where appropriate. The Food and Drug Administration would establish a system of user fees for the review of drugs and medical devices, including products that use techniques developed through biotechnology. By substantially increasing the resources available to the FDA, user fees will enable that agency to speed its review of biotechnology products and, in turn, allow firms to bring their products to the marketplace sooner.

SUPERCONDUCTING SUPER COLLIDER (page 64)

The Superconducting Super Collider will help scientists explore aspects of matter that are unreachable using any existing facility, and it holds the potential for new breakthroughs in science, technology and education.

The 1991 budget provides $318 million in budget authority for the SSC, an increase of $100 million over the 1990 level. The budget supports work to complete the design, development, and testing of the magnets that will propel proton beams around the tunnel. R&D on other SSC technical systems will continue.

C. ENHANCING RESEARCH AND DEVELOPMENT (page 67)

The budget proposes to allocate almost $71 billion in budget authority for research and development in 1991. This is an increase of $4.5 billion, or 7 percent, over 1990 enacted levels. Civilian R&D will increase by 12 percent while Defense-related R&D will increase by 4 percent. Within this total, $12 billion will be allocated for basic research, an increase of $1 billion, or about 8 percent over FY 1990.

1. *Doubling of the National Science Foundation:* A 14 percent increase will continue progress toward doubling the NSF budget by 1993. (page 74)
2. *Global Change:* An increase of 57 percent for the U.S. Global Change Research Program (USGCRP), to a total of over $1 billion. This program continues the U.S. world leadership role in climate change research. (page 75)
3. *Agricultural Research Initiative:* The budget proposes $100 million in budget authority as the first step of a new agricultural research program, designed to enhance production efficiency, food safety, and environmental quality. (page 77)
4. *Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome:* An overall increase of 18 percent in allaspects of the Federal response to HIV/AIDS: research, prevention, treatment, and income support. (page 78)
5. *R&D for Advanced Technology:* $192 million in budget authority, an increase of 28 percent for robotics R&D, and continued support for R&D on high performance computing, semiconductors, superconductivity and advanced imaging. (page 84)
6. *Magnetic Levitation Transportation:* An increase of nearly 400 percent to $10 million in budget authority to explore this potentially important transportation technology. (page 84)
7. *Science and Engineering Education:* The budget proposes over $1 billion in budget authority, an increase of 26 percent above 1990 in direct spending, for science and engineering education activities in five agencies. In addition, the budget provides research grants to universities in direct support fellowships and other forms of education support. (page 87)
8. *R&E Tax Credit:* The budget proposes to make the Research and Experimentation Tax Credit permanent. (page 91)
9. *R&D by Transnational Companies:* The budget proposes to make permanent the rules for allocation of R&D expenditures by transnational companies. (page 91)

D. INVESTING IN HUMAN CAPITAL (page 93)

EDUCATION (page 93)

The total 1991 budget requests for the Department of Education are the highest ever: $24.6 billion in budget authority. Included is $19.7 billion in budget authority for discretionary programs, $1.2 billion more than Congress provided in 1990.

1. *Preparing Children to Learn:* (page 99)
   - a. *Head Start:* increase by $500 million in budget authority, to a record high total of $1.9 billion. This 36 percent increase over the 1990 level would enable Head Start to enroll up to 70 percent of the eligible poor four year olds. (page 100)
   - b. *Even Start:* double funds to $48 million in budget authority, allowing significantly increased participation in this program designed to provide basic education services in low-income areas to parents together with their children, aged one through seven. (page 101)
   - c. *Handicapped Infants:* $83 million for the Education Department to develop and expand systems to find, and coordinate services for handicapped infants and their families. (page 101)
   - d. *Handicapped Children:* $258 million in budget authority under the Preschool State Grant program to pay for part of the excess cost of education and related services for handicapped children aged three to five. (page 102)
2. *Targeting Resources for Those Most in Need:* (page 102)
   - a. *Elementary and Secondary Education:* increase the largest program for remedial education services for the disadvantaged—Chapter 1 Local Education Agency and Concentration Grants—to its highest level ever: $4.96 billion in budget authority, an increase of $366 million, 8 percent over 1990. (page 102)
   - b. *Educational Excellence Act:* $401 million in budget authority. This proposed legislation would give incentives to schools to improve educational achievement, expand the use of magnet schools, reward excellent teachers and students, promote the hiring of persons with proven subject matter knowledge and management abilities to be teachers and principals, increase the endowment funds of Historically Black Colleges and Universities, and provide special funding for the school districts with the worst drug abuse problems. (page 103)
   - c. *Math and Science:* $230 million in budget authority for the Dwight D. Eisenhower Mathematics and Science Education programs, a 70 percent increase over what Congress provided in 1990. These programs provide funds to States to improve the knowledge and teaching abilities of mathematics and science teachers. (page 104)
   - d. *Literacy:* $239 million in budget authority for the Adult Education programs of the Department of Education, an increase of more than 25 percent over what Congress provided in 1990. These programs include an Adult Literacy

Clearinghouse at the Department of Education. (In addition, funding is proposed to be doubled from $3 million to $6 million in 1991 for the VISTA—Volunteer in Service to America—Literary Corps of the ACTION agency.) (page 104)

e. *Historically Black Colleges and Universities:* $95 million in budget authority to support the operations of historically black colleges and universities and graduate institutions. An additional $15 million is provided for matching endowment grants for these institutions, triple the amount provided in 1990. (page 104)

3. *Education Research and Statistics:* The budget provides for an increase of $34.5 million in budget authority for primary research and statistics activities of the Education Department. This includes a 50 percent increase for statistics, from $40 million in 1990 to $60 million in 1991. Among the most important new research investments proposed are: (page 98)

a. $5 million for new research on dropout prevention. (page 99)

b. $22 million for support for a network of national research and development centers conducting research on educational technology, reading, effective teaching for the disadvantaged, school leadership, and other subjects. (page 99)

c. $7 million for the Educational Resources Information Center. (page 99)

d. $20 million for the regional education laboratories to support local school improvements efforts. (page 99)

JOB TRAINING

4. *Improving Job Training Opportunities:* (page 104)

a. *The Job Training Partnership Act:* The budget seeks to refine the Federal Government's role in the Job Training Partnership Act (JTPA) by: revising eligibility criteria to ensure that the most disadvantaged receive services; providing more intensive and comprehensive services to participants; and improving coordination among Federal, State and local human resource programs. (page 106)

b. *Youth Opportunities Unlimited:* The Administration has proposed a new, multi-year challenge grant program entitled Youth Opportunities Unlimited (YOU). Targeting high poverty inner cities and rural areas, this program is designed to have community-wide impact, serving as a model in developing a local coordinated human resource policy for at-risk youth. (page 108)

c. *Job Opportunities and Basic Skills:* This program was enacted as part of the Family Support Act of 1988. The 1991 budget includes $1 billion for this program. (page 108)

ENHANCING PARENTAL CHOICE IN CHILD CARE (page 194)

Respecting the many ways that American families care for their children, the President has based his child care policy upon parental choice. The budget reproposes the two tax credit initiatives for child care that were advanced last year: (1) a new refundable Child

Tax Credit for low-income working families of up to $1,000 for each child younger than age four, and (2) refundability of the current Child and Dependent Care Tax Credit.

E. ENDING THE SCOURGE OF DRUGS (page 111)

The 1991 Federal drug control budget totals $10.6 billion in budget authority. This budget will provide $9.7 billion in outlays, $2.8 billion more in outlays than last year—a 41 percent increase.

1. *Attacking the Drug Market at the Source and on the Street:* (page 112)

a. *At the source:* (page 112)

- an increase of $175 million in budget authority in economic assistance for the Andean nations to complement military and law enforcement programs begun in 1990. If the Andean nations show demonstrable progress in 1990, the total assistance package will reach $440 million in 1991.
- A $15 million in budget authority increase is proposed for drug control programs in countries that now produce marijuana and heroin, or serve as trans-shipment points for those substances.
- $35 million in budget authority is requested for domestic marijuana eradication.
- $2.4 billion in budget authority proposed for air, land, and maritime interdiction operations would provide obstacles to drug smugglers, including seizure of illegal shipments, and can ultimately reduce the availability of drugs in the U.S.

b. *On the street:* (page 113)

- $330 million in budget authority for the 13 regional Organized Crime Drug Enforcement Task Forces. This represents a 54 percent increase over 1990.
- $50 million in budget authority, a $25 million increase over 1990, proposed to be targeted on high intensity drug trafficking areas.
- An estimated $238 million in budget authority from seizures will be shared with State and local law enforcement agencies—their fair share of Federal seizures of drug dealers' assets.
- $700 million in budget authority for the Drug Enforcement Administration (DEA). The $151 million increase over 1990 represents one of the largest annual increases in the history of the agency.
- Within the DEA budget request is a 30 percent increase for State and local task forces to $42 million in budget authority in 1991.
- $172 million in budget authority, a $32 million increase over 1990, is requested for the FBI's anti-drug abuse activities.
- $182 million in budget authority for the U.S. Attorneys to prosecute drug dealers and users, a $45 million increase over 1990. A 30 percent increase, a total request of $201 million, for the U.S. Marshals is also proposed.

- $79 million in budget authority increase for the Judiciary branch, for a total of $403 million, to try accused drug offenders.
- $492 million in budget authority is requested for State and local law enforcement grants, a 10 percent increase over 1990.
- The Administration has proposed legislation to require States to adopt drug-testing programs throughout their criminal justice systems as a condition for receipt of Federal criminal justice funds.

2. *Treating the Drug User:* (page 114)

For 1991, the Administration requests nearly $1.7 billion in budget authority for drug treatment activities, a 12 percent increase over 1990. This includes:

a. $760 million for Alcohol, Drug Abuse and Mental Health Administration (ADAMHA) drug treatment grants and technical assistance for the States, an increase of 11 percent over 1990. (page 116)

b. $300 million for the Department of Veterans Affairs to provide drug treatment services. (page 116)

c. Tripling the assistance for the smallest victims of the drug problem, "crack babies." (page 116)

d. An increase of $30 million for treatment research and data collection by HHS. (page 116)

3. *Preventing Drug Abuse: School, Workplace, and Community Prevention:* (page 116)

The 1991 budget requests an increase of 12 percent over 1990, or a total of $1.4 billion in budget authority for drug prevention and education activities. This includes:

a. $496 million for drug prevention programs in the Department of Health and Human Services: Many of these programs fund prevention demonstration projects and research for high-risk youth populations. Drug prevention efforts for pregnant women remain a priority. (page 118)

b. $593 million for the Education Department's Drug-Free Schools and Communities Program: This represents a $54 million increase over 1990. (page 118)

c. $150 million for drug programs for the Department of Housing and Urban Development, of which approximately half will be directed at preventing drug abuse in and around housing projects. (page 118)

Federal efforts will continue to support a drug-free Federal workplace. The Administration also will propose to strengthen drug-free workplace requirements for Federal contractors and grantees. (page 118)

F. PROTECTING THE ENVIRONMENT (page 119)

The budget provides over $2 billion in new budget authority for initiatives to protect the environment.

1. Exercising Responsible Stewardship of America's Natural Resources: (page 120)

   a. *America the Beautiful:* The budget proposes to establish a new "America the Beautiful" initiative comprised of the following: (page 120)

   - *Land Acquisition:* The budget proposes to expand acquisition of high priority national parks, refuges, forests, and other public lands. The budget requests $250 million in budget authority in 1991 for these purposes.

   - *Reforestation:* The budget proposes $175 million in budget authority for the first year of a multi-year initiative with these objectives: planting a billion trees on private land across America; and launching a community trees program, designed to plant another 30 million trees in towns and cities across America.

   - *Enhancing recreation and restoring natural resources:* Legacy '99: The budget includes $205 million in budget authority, 40 percent above 1990, for improved resource protection and restoration (including wetlands conservation and endangered species activities) and enhanced recreational opportunities in national parks, wildlife refuges, and other public lands.

   b. *Protecting America's Wetlands:* The budget proposes an increase of $88 million in budget authority, 24 percent above 1990, for wetlands research, protection, preservation, and enhancement. (page 123)

   c. *Mitigating the Environmental Effects of Water Resource Development:* (page 124)

   - The budget proposes $16 million in budget authority for the Army Corps of Engineers to construct juvenile fish passage facilities on the Columbia and Snake Rivers in Washington, Oregon, and Idaho.

   - The budget provides $20 million in budget authority to begin the acquisition of 88,000 acres needed to mitigate environmental losses caused by the construction of the Tennessee-Tombigbee Waterway project in Alabama and Mississippi.

   d. *Managing America's National Forests:* The budget proposes to end "below-cost" timber sales, on nine test forests where recreation and other uses have been increasing. "Above cost" sales on these forests will be allowed. (page 123)

2. *Providing Tools for Effective Pollution Control:* (page 126)

   a. *Increase EPA's Operating Budget:* $230 million in budget authority, a 12 percent increase above 1990, for EPA's operating budget. The increase would bring staffing growth since the beginning of the Administration to 1,630—an 11 percent increase. (page 126)

   b. *Implementing Clean Air Changes:* An increase of over $80 million in budget authority is requested to enable the agency to implement the ambitious new proposals for revising the Clean Air Act proposed by the President last year. (page 126)

c. *Enforcing Environmental Laws:* The budget calls for a 36 percent increase in EPA's enforcement budget. This will enable EPA to redouble its efforts to ensure that responsible parties pay for cleaning up the pollution they create. (page 126)

d. *Protecting Critical Habitats:* The budget provides $95 million in budget authority, an increase of 32 percent, for EPA's critical habitat programs, which seek to address pollution problems in the Nation's wetlands, estuaries, and near coastal waters. (page 127)

e. *Revitalizing the Council on Environmental Quality:* The budget for CEQ will nearly double. (page 127)

f. *Promoting Environmental Education:* In 1991, the President will present a cash award of $5,000 to the 100 teachers—two in each State—who design and implement the most innovative and effective programs to teach students about the environment. (page 128)

g. *Maintaining Environmental Infrastructure:* The budget proposes a $91 million in budget authority expansion of the maintenance and rehabilitation efforts by the Department of the Interior that preserve the basic infrastructure of America's national parks, wildlife refuges, and other public lands. This is a 19 percent increase above 1990. (page 128)

3. *Cleaning Up Hazardous Wastes:* (page 129)

a. *Accelerating the Pace of Superfund Cleanups:* The President has requested an increase of over $200 million, which will be targeted toward cleanups. (page 129)

b. *Cleaning up Federal Facilities:* The budget proposes an increase of nearly $800 million in budget authority, or 21 percent above 1990 levels, for Federal facility cleanup efforts. (page 129)

4. *Laying the Groundwork for a Cleaner, Safer Future:* (page 129)

a. *Global Climate Change Research:* The budget contains over $1 billion in budget authority, an increase of 57 percent over the 1990 levels, for the U.S. Global Change Research Program, an interagency research effort designed to improve scientific understanding and predictive capability on global change issues. (page 129)

b. *Encouraging the Development of Solar and Renewable Energy Sources:* The budget requests about $360 million in budget authority for these activities, a substantial increase over the $208 million requested in 1990. The budget will also request $182 million for energy conservation R&D, almost double the 1990 request. (page 131)

G. IMPROVING THE NATION'S TRANSPORTATION INFRASTRUCTURE (page 133)

AVIATION

The President is proposing a total of $8.6 billion in budget authority, a 16 percent increase, for aviation programs in 1991. This is the first year of a 5-year aviation reauthorization program to provide the necessary funding to modernize and expand the aviation infrastructure. (page 134)

1. *Keeping the Skies Safe and Secure:* The Administration is requesting $4.1 billion, a $264 million or 7 percent increase over 1990, for Federal Aviation Administration (FAA) operations. The budget also includes a $20 million or 12 percent increase over 1990, for aviation research and development. (page 135)
2. *Modernizing Airspace System Equipment:* The budget proposes $2.5 billion in budget authority, an increase of $779 million, or 45 percent. (page 135)
3. *Expanding Airport Capacity:* (page 136)
    a. *Increasing Federal funding for capacity projects:* The President's budget provides $1.5 billion in new 1991 spending for Federal airport grants, a $75 million increase over 1990. (page 137)
    b. *Removing Federal restrictions:* The Administration proposes to remove existing statutory restrictions that prevent airports from raising certain revenue—namely by allowing airports to levy passenger facility charges (PFCs). Some estimates show PFCs could generate about $1 billion per year for U.S. airports. (page 137)
4. *Financing the Aviation System:* The Administration proposes to increase aviation user fees to finance these significant increases in aviation spending. The passenger ticket fee would be raised from 8 to 10 percent and other aviation fees would be raised similarly. (page 137)

HIGHWAYS

For 1991, the budget provides Federal-aid highway funding to cover the Federal share of the cost to maintain the physical condition of bridges and highways of national importance and to continue completion of the Interstate System. The Federal-aid highway program is authorized through 1991. During this year, the Federal Government will work with its partners—States, local governments and the private sector—to address the projected needs for highways. The Administration will present its proposals in the context of the highway reauthorization for 1992 and beyond. (page 138)

H. BRINGING HOPE TO DISTRESSED COMMUNITIES (page 141)

1. *Expanding Tenant Management and Homeownership Opportunities:* (page 141)
    a. *HOPE Grants:* To help low-income families become homeowners with a stake in their communities, the Administration proposes a new HOPE Grant Program. These grants will provide funds for resident management and homeownership in public housing, government-held vacant and foreclosed properties, and financially "distressed" properties. HOPE Grants will provide $2.15 billion over 3 years with States, localities, or non-profit organizations

required to provide $1 for every $2 in Federal HOPE Grant funds. A total of $250 million will be set aside to provide replacement housing for public housing developments that convert to low-income homeownership. (page 144)

b. *Urban Homesteading:* The budget almost quadruples funding for this program for a total of $50 million in 1991. (page 145)

c. *Prepayment Strategy:* The HOPE initiative proposes a three-pronged approach to protect tenants who would be adversely affected by much higher and unaffordable rents in housing projects where owners will become eligible to prepay their mortgages. (page 145)

d. *IRAs for Homebuyers:* To expand homeownership for young families and first-time homebuyers, the Administration proposes the use of Individual Retirement Accounts (IRAs) for buying a home. (page 146)

2. *Reducing or Eliminating Barriers to Low-Cost Housing:* (page 146)

   a. *Housing Opportunity Zones:* The budget proposes a Federal-local partnership to remove barriers to, and create incentives for, more affordable housing for low and moderate income families in distressed areas through designation of 50 housing opportunity zones, chosen through a competitive process. (page 146)

   b. *Low-income Tax Credit:* The budget proposes to extend the low-income housing tax credit through December 1991 to encourage the new construction or rehabilitation of affordable rental housing in areas with rental housing shortages. (page 146)

3. *Helping Poor Families and Elderly Become Self-Sufficient:* (page 147)

   a. *Operation Bootstrap:* Starting in 1991, all housing vouchers provided to welfare families and others with very low incomes must be combined with a local program to help them escape from dependency. (page 147)

   b. *Frail Elderly Housing Services Voucher:* The 1991 budget proposes a Service-Supported Housing Voucher Demonstration for the frail elderly—those persons of at least 62 years of age who need assistance with three or more simple activities of daily living—funded at $44 million. $34 million of housing vouchers will be linked with $10 million for in-home services. (page 147)

4. *Helping the Homeless:* (page 147)

   a. The budget includes $819 million for the *McKinney Act* programs, more than the $727 million needed to "fully fund" the Act. (page 147)

   b. *Special Homeless Initiatives:* (page 147)

      - *AFDC Families in Welfare Hotels:* The budget proposes a total of $143 million for the McKinney Act Transitional Housing Demonstration program. This program is designed to develop innovative approaches to providing houses and supportive services to homeless individuals and families who can make the transition to independent living within 2 years.

- A new *"Shelter Plus"* Program to help the homeless mentally ill or recovering substance abuser. HUD would provide $247 million in housing assistance for over 8,900 homeless mentally ill or recovering substance abusers.

5. *Creating Jobs and Economic Growth in Distressed Areas:* (page 148)

   a. *Enterprise Zones:* Three tax incentives are included in the President's budget to encourage job creation and entrepreneurship in distressed areas: (page 148)

   - A 5 percent refundable tax credit for the first $10,500 of wages, up to $525 per worker, to qualified employees for wages earned in an enterprise zone business.
   - Expensing of investor purchases of newly issued corporate stock of businesses located in enterprise zones. This is an up-front deduction for up to $50,000 per year of new equity investment, with a $250,000 lifetime limit.
   - A zero capital gains rate for gains on investment in tangible property used in an enterprise zone business and located within an enterprise zone at least two years.

I. PRESERVING NATIONAL SECURITY AND ADVANCING AMERICA'S INTERESTS ABROAD (page 151)

NATIONAL DEFENSE

The budget request for national defense is significantly less ($14.3 billion in budget authority and $5.5 billion in outlays) than the amounts included in the President's February 1989 budget for 1991. Budget savings in the 1991–93 period (relative to the previously-published levels) are $63.6 billion in budget authority and $29.7 billion in outlays. The actual savings relative to the full cost of the previously approved defense program are considerably higher—almost $170 billion over 5 years. (page 151)

1. *Department of Defense—military:* The budget requests $295.1 billion in budget authority and $292.1 billion in outlays for the military functions of the DOD: (page 153)

   a. *Operations:* Active duty end-strength will decline by the end of 1991 to a level of 2,038,800—91,429 below the actual FY 1989 level—with savings of $1.7 billion. At the same time, to continue to assure force quality, readiness and training, the budget provides for a 3.5 percent pay raise, improved benefits, enlistment and re-enlistment bonuses, special pay for critical skills, and continuation of current training levels. (page 154)

   - *Strategic forces:* Deployed forces will continue to include the Triad of land, air, and sea based systems, as well as air defense interceptors.
   - *General purpose forces:* Land forces at the end of 1991 will include 19 active and 11 reserve Army and Marine divisions, two active divisions less than at the end of 1990. Naval forces will include 14 aircraft carrier battle groups and 15 tactical airwings (the same as in 1990), but two of the four U.S. battleships will be deactivated and the number of nuclear attack submarines will decrease by 5 in 1991. Air forces will include 24 active and 12 reserve Air Force fighter wing equivalents, 2 squadrons of B–52's dedicated to the

delivery of conventional weapons, and 25 strategic airlift squadrons. One Air Force fighter wing equivalent and one conventional B–52 squadron will be deactivated in 1990.

- *Special operations forces:* Through 1991, Army special forces battalions will increase from 13 to 15, and Air Force special operations units will gain 7 additional aircraft.

b. *Investment:*

- *Strategic systems:* To modernize all three components of the strategic Triad, procurement for 1991 includes the eighteenth Trident submarine and 52 Trident II missiles, 12 Peacekeeper missiles for operational testing and special railroad trains to provide mobility for Peacekeeper missiles. The budget requests funds for continued development of the small intercontinental ballistic missile. It also requests an increase for the Strategic Defense Initiative to a level of $4.5 billion. This is $0.9 billion more than in 1990, but $1.0 billion less than previously planned.

- *Conventional systems:* To maintain well-equipped forces, the budget provides for procurement in 1991 of 225 M–1 Abrams tanks, 600 Bradley Fighting Vehicles, 72 Blackhawk utility helicopters, 14 new ships, 186 Air Force fighters, and six C–17 transport aircraft. Development will continue on the Army's experimental light helicopter (LHX) and improved ground force systems, the Advanced Air-to-Air Missile System, P–7 anti-submarine warfare aircraft, and next generation tactical aircraft. Fifteen systems will be terminated with associated savings of $3 billion. These are in addition to the five systems terminated in the FY 1990 budget.

- *Research and Technology:* The budget requests $38.0 billion in budget authority and $37.0 billion in outlays for research, development, testing and evaluation—$1.2 billion and $0.4 billion, respectively, more than 1990 levels. The request includes $3.4 billion to develop technology options for future U.S. weapon systems and to guard against technological surprise by our adversaries.

c. *Base Closures:* The budget requests $916 million for continued implementation of the Base Closure and Realignment Act approved by Congress in 1989. $500 million was provided in the 1990 budget for this purpose. Additional domestic base closures will be studied this year and units will be withdrawn from some overseas bases. (page 156)

d. *Drug Interdiction:* The budget requests $1.2 billion for an aggressive Defense counternarcotics program, $0.3 billion more than 1990. (page 156)

2. *Atomic Energy Activities:* The budget proposes budget authority of $11 billion and outlays of $10.4 billion, compared to $9.7 billion and $8.9 billion, respectively, for 1990. (page 156)

The budget includes $2.8 billion in budget authority for waste cleanup at various Department of Energy facilities. This represents an increase of $601 million, or 27 percent above 1990. The budget also includes an increase of $178 million in budget authority for Federal facility cleanup activities in other agencies.

Governmentwide, the increase above 1990 for Federal facility cleanup is 21 percent. (page 257)

3. *Defense-Related Activities:* These activities include civil defense and emergency preparedness activities of the Federal Emergency Management Agency, the efforts of the Selective Service System, and the Maritime Administration's Ready Reserve Force. The budget requests $760 million in budget authority and $705 million in outlays for these purposes, as compared with $609 million and $648 million, respectively, in 1990. (page 157)

INTERNATIONAL AFFAIRS

The budget requests budget authority of $20 billion and outlays of $18.2 billion for international affairs activities, $1.4 billion and $3.6 billion more, respectively, than in 1990. The high growth in outlays reflect in part the cessation in 1991 of certain large receipts. (page 158)

1. *Foreign Aid:* The budget requests $14.9 billion in budget authority and $14.2 billion in outlays for foreign aid, $1 billion and $3 billion, respectively, more than in 1990. Much of the increase in outlays in 1991 is due to the prepayment in 1990 of past loans for military goods and services. The budget reflects an emphasis on Eastern Europe, counter-narcotics, and the U.S. role in the multilateral development banks (MDBs). (page 159)

   a. *Security Assistance:* The budget requests $8.8 billion in both budget authority and outlays for international security assistance, $0.4 billion and $2.5 billion, respectively, more than in 1990. The largest component of security assistance requested—$5.1 billion, or 61 percent—provides military and economic support to Israel and Egypt. Furthering their efforts to achieve a lasting peace in the Middle East remains a high priority of U.S. foreign policy. (page 160)

      - *Narcotics control:* The budget requests $528 million in budget authority and $270 million in outlays for international narcotics control. The requested funding will finance the second year of the plan to reduce the flow of cocaine from the Andean countries of Colombia, Peru, and Bolivia. The major increment in this program will be $175 million of new aid for the economies of those countries that evidence a determination to attack seriously the narcotics problem.

   b. *Development and Humanitarian Assistance:* The budget proposes $6.1 billion in budget authority and $5.4 billion in outlays for development and humanitarian assistance, $0.6 billion and $0.5 billion, respectively, more than in 1990. This funding is to encourage market-oriented economies through budgetary support, capital projects and technical assistance; to provide relief from major disasters; and to provide humanitarian assistance such as refugee care. The request includes $1.9 billion in budget authority for bilateral economic assistance programs administered by AID and $1.7 billion in budget authority for U.S. contributions to multilateral development banks such as the World Bank. (page 161)

      - *Special assistance for Eastern Europe and the Philippines:* The major emphasis of the increases in foreign aid in 1991 is support of democracy abroad. The budget requests $300 million for a special assistance initiative for those countries in Eastern Europe that are moving toward democracy and attempting to develop free-market economies. The budget also requests $200 million for special assistance to the Philippines.

- *Refugees:* The budget requests $451 million in budget authority and $435 million in outlays for refugee programs, $82 million and $49 million, respectively, more than in 1990.

- *Multilateral development assistance:* The budget requests $3.2 billion in contributions over the next 3 years to the International Development Association (IDA), an agency of the World Bank. This proposed funding, when matched by funding from other countries, will permit IDA to provide an average of $5.5 billion in annual long-term lending to the poorer developing countries.

2. *Diplomacy:* The budget requests budget authority of $5.3 billion and outlays of $4.5 billion, $1 billion and $0.4 billion, respectively, more than in 1990. (page 161)

   a. *The conduct of foreign affairs:* Funds sought for the basic salaries and expenses of the State Department are $1.9 billion in budget authority and $1.8 billion in outlays. (page 162)

   - *Payments to international institutions:* The budget requests $1.4 billion in budget authority and $0.9 billion in outlays for international organizations that are important to U.S. interests, an increase of $712 million and $187 million, respectively, over 1990 levels. The request includes $794 million for regularly scheduled payments and $620 million to eliminate arrearages in U.S. mandatory contributions to the United Nations and related agencies.

   - *Reconstruction of the Moscow Embassy:* The budget requests $270 million in budget authority and $10 million in outlays to construct, under extraordinary technical standards, a more secure building for diplomatic representation and negotiations.

   b. *Public Diplomacy:* Among the various programs in this area, the budget requests $154 million for exchange programs and $125 million for USIA's Voice of America to continue its major modernization of radio broadcasting capacity. (page 162)

3. *International Financial Programs:* For 1991, the Export-Import Bank will provide $500 million in loans and $10.6 billion in guarantees and insurance to support U.S. export sales. (page 163)

J. PRESERVING AMERICA'S HERITAGE (page 165)

The budget proposes $757 million in direct funding of activities that preserve, pass on and contribute to the American heritage, 9 percent more than enacted in 1990.

1. *National Endowment for the Arts:* The budget requests $175 million in budget authority for the National Endowment for the Arts, $4 million more than enacted in 1990. (page 166)

2. *National Endowment for the Humanities:* $165 million in budget authority for the National Endowment for the Humanities, $8 million more than enacted in 1990. (page 166)

3. *Institute for Museum Services:* $24 million in budget authority for the Institute of Museum Services, $1 million more than enacted in 1990. (page 166)

4. *Smithsonian Institution:* $308 million in budget authority for the Smithsonian Institution, roughly $41 million more than enacted in 1990. The budget includes $19.4 million toward establishment of a new National Museum for the American Indian. (page 167)

5. *National Gallery of Art:* $49 million in budget authority for the National Gallery of Art, $7 million more than enacted in 1990. (page 167)

6. *Historic Preservation Fund Program:* $34 million in budget authority for theHistoric Preservation Fund Program of the National Park Service, $1.4 million more than enacted in 1990. (page 167)

II. ADVANCING STATES AS LABORATORIES (page 169)

The President's budget highlights and expands the effort of the Federal government to foster and finance innovation in the States. In the areas of education and low-income programs in particular, the President's program supports important innovations and experiments, including steps to reduce Federal controls and regulations in order to give State Governors and legislators greater latitude to try new methods.

III. REFORMING MANDATORY PROGRAMS (page 181)

Mandatory spending encompasses entitlements and a wide variety of other benefits, services, and subsidies ranging from social services to electric power distribution subsidies. The element common to all mandatory spending is that it tends to be "automatic" in the sense that it is not normally controlled through the annual congressional appropriations process in the way other spending, termed "discretionary" is. Mandatory spending is now almost half of total Federal spending and will exceed 50 percent by 1994.

The sheer size of the mandatory program universe dictates careful attention to spending, which if allowed to grow unexamined can limit the Nation's future in several ways. Reforms are proposed in a number of mandatory programs, though most mandatory programs will still have higher outlays in 1991 than 1990.

IV. ACKNOWLEDGING INHERITED CLAIMS (page 213)

A. ACCOUNTING FOR DEBT AND UNFUNDED ANNUITIES

The Government owes $2.2 trillion of principal to the people who have loaned it the money to pay for past deficits. This year it will pay an estimated $176 billion of net interest. The present deficit is continuing to increase the amount of debt, although less rapidly than several years ago.

Annuity programs have also created large and growing obligations on future taxpayers. The Government spent $382 billion in 1989 for social security, medicare, and Federal employee retirement programs, and the budget estimates it will spend $433 billion in 1991. These programs are projected to become much larger relative to the economy in future decades than they are now.

A thorough discussion of possible future claims under this heading is at pages 215–228 of the *Budget*.

B. FEDERAL UNDERWRITING RISKS—CREDIT AND INSURANCE PROGRAMS

The Federal Government is the Nation's largest source of credit and underwriter of risk. Too little attention was paid in the past to the scope and scale of these commitments, and often the Government's potential exposure was understated or ignored. Events of the past few years, including insolvency of the Federal Savings and Loan Insurance Corporation and many insured thrifts, the bailout of the Farm Credit System, and mounting losses in mortgage insurance programs, provide hard evidence of the magnitude of the threat. This budget reexamines and begins to restructure Federal credit and insurance programs. Please see pages 229–255 for a more complete discussion of these issues than has been presented in previous budgets.

C. CLEANING UP FEDERAL FACILITIES

The President is committed to cleaning up environmental contamination from past practices at federally owned facilities across the country, and to ensuring that Federal agencies meet or exceed all environmental standards required by relevant laws and regulations. Agencies have the responsibility to operate within these laws, and citizens have the right to insist that Federal agencies be good neighbors.

The budget contains major increases in funding for several agencies that will result in significant progress toward the goal of bringing Federal facilities into compliance with environmental laws. (pages 257–262)

V. MANAGING FOR INTEGRITY AND EFFICIENCY (page 263)

A. REFORMING THE BUDGET PROCESS (page 265)

The congressional budget process does not work well. The budget suggests several reforms to improve the discipline and effectiveness of the Federal budgeting system:

1. Joint budget resolution (page 265)
2. Improved budget measuring and "scorekeeping" (page 265)
3. Biennial budgeting (page 265)
4. Enhanced rescission authority (page 266)

5. Restraining supplemental appropriations (page 266)
6. Closing loopholes in G-R-H (page 267)
7. Reinforcing sequester (page 267)
8. Protecting the social security trust fund (page 267)
9. Amending the Constitution (page 268)
   - Balanced budget amendment
   - Line item veto

B. RESTORING A BASIS FOR CONFIDENCE (page 271)

1. *Reducing Investment in Low Return Programs* (page 271)

Total budget authority for domestic discretionary programs, which are defined as those controlled through the annual appropriations process, is proposed to increase from $160.5 billion in 1990 to $167.4 billion in 1991. Outlays are estimated to increase from $184.2 billion in 1990 to $194.4 billion in 1991. These changes are the net result of many proposed increases and decreases. Previous sections have highlighted increases. This section of the budget details the principal decreases in domestic discretionary programs.

2. *Strengthening Management Oversight* (page 278)

American citizens have the right to expect that their Government will not tolerate recurrent scandals, such as in housing programs and procurement for national defense. They have the right to better assurance that Federal activities will not pollute the neighborhoods in which they operate or the ecosystem itself. They have the right to expect that their hard earned tax dollars will go to broad national purposes and not to those who can muscle legislators or officials for special breaks. Americans also have the right to first rate service delivery, systems to provide for Government efficiency and integrity, and a skilled and well-motivated Federal workforce. Better provision for these rights and expectations will improve the basis for confidence in democratic institutions.

The budget requests $22.1 billion in budget authority and $19.9 billion in outlays—$2.9 billion and $2.4 billion, respectively, more than in 1990—to improve Government management.

Initiatives to strengthen management oversight include:

a. *Defense Management Reform:* The budget includes 1991 management savings in the Department of Defense's operations of $2.3 billion. These savings will result from implementation of the recommendations in the Defense Management Report, which the President transmitted to Congress in July 1989. Personnel reductions of approximately 8,000 civilians and 8,000 military are expected in 1991 as a result of these reforms. In addition, the Department of Defense estimates these savings will increase to a total of $39 billion by 1995. (page 283)

b. *Enhanced Collection of Taxes and Tax Debt:* To slow the growth in tax debt (currently $61 billion), the budget includes funding for the first phase of a 3-year tax collection initiative, the overall objective of which is to increase collections by $2.25 billion over the 1991–93 time period. The first phase will generate $759 million in revenues over this interval from 1,050 additional collection personnel to be hired in 1991. The Internal Revenue Service also plans to reallocate existing resources so as to provide additional revenues of $2.5 billion in 1991. (page 284)

c. *Enhanced Collection of Non-Tax Debt:* The budget requests an additional $55 million to accelerate non-tax collections, an investment which will improve management controls and realize a return of $200 million in 1991. Additional staff positions are planned for account servicing in the Department of Agriculture's Farmers Home Administration and the Department of Veterans Affairs. Over 400 positions have been allocated to HUD field offices to improve portfolio management. (page 284)

d. *Selected Improvements in Service Delivery:* To improve service delivery, the budget requests $6.1 billion and over 120,000 staff in 1991 for the IRS, $635 million more than in 1990; $4.2 billion for operating the Social Security Administration, $330 million more than in 1990; $8.6 billion for the Federal Aviation Administration (FAA), $1.2 billion more than in 1990; $507 million for selected Federal economic statistics programs, $52 million more than in 1990. (page 280)

e. *Rebuilding the Public Trust:* The budget requests an increase of $76 million, 10 percent more than 1990, and 670 additional staff who will assist in implementing the HUD Reform Act of 1989. The budget also requests an increase of $32 million for HUD automated data systems, including financial management systems, 44 percent more than in 1990, and $8 million for the HUD Inspector General to improve monitoring and review of HUD programs. (page 280)

f. *Strengthening the Savings and Loan Industry:* The Administration proposed comprehensive reform, and Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 in August. The legislation imposes a number of new requirements on the industry and its regulators to assure the safety and soundness of nearly $1 trillion of insured deposits; it also establishes a Resolution Trust Corporation (RTC) to handle the merger, sale or liquidation of 500–600 insolvent S&Ls. (page 280)

g. *Cleaning up Hazardous Waste Dumps:* The Environmental Protection Agency will in 1990 increase enforcement and tighten oversight of the Superfund toxic waste response program. EPA will impose a 120-day deadline on negotiations with polluters and exercise its authority to order cleanup if settlement is not reached. Increased enforcement has already resulted in $1 billion in polluter-financed clean-up activities for 1989, nearly double that in 1988. The budget provides for a $210 million increase in 1991 to clean up additional hazardous waste sites. This investment builds on the actions of the Administration to provide 480 additional staff at the Department of Justice and EPA (a nearly 40 percent increase) to strengthen Superfund enforcement in 1990. (page 281)

h. *Improving the Integrity of Student Aid Programs:* To reduce guaranteed student loan defaults and other losses from inadequate program management, the Department of Education is pursuing a three-pronged strategy of strengthened regulations, administrative actions, and changes in law. (page 281)

i. *Improving Pension Oversight:* The budget requests an increase of 133 investigative and legal support staff and an additional $9.3 million in the Department of Labor to strengthen oversight of private pension plans through the Pension and Welfare Benefits Administration. The additional staff will enable the Department to increase reviews and investigations by more than 50 percent and reporting enforcement investigations by 80 percent. (page 281)

j. *The Inspectors General:* Over the 2-year period 1990 to 1991, the budget specifically adds 67 staff and $6.9 million for the Department of Energy to deal with procurement fraud, increase audits (including environmental audits), and increase investigations and analysis. It also includes resources for additional audit coverage of international program activities at the Department of Agriculture; increased audit and investigation coverage of the Pell Grant, education for the handicapped and student loan programs at the Department of Education; increased auditing and investigative work at the Department of the Interior; enhanced ADP capabilities at the Department of the Treasury; additional personnel to provide adequate coverage of the Superfund and underground storage tank programs at EPA; and additional audits of contractors at NASA. (page 281)

k. *Internal Controls and Audit Follow-up:* The budget requests $3 million and 41 staff to establish or augment offices better to coordinate and manage internal controls and audit follow-up at the Departments of Agriculture (Farmers Home Administration), Housing and Urban Development, Interior and Veterans Affairs, and at NASA. Working with the agencies, OMB has identified more than 100 high-risk areas; and a central tracking system has been established to monitor corrective actions. Deputy Secretaries and Deputy Administrators have been told that it is their personal responsibility to ensure that management integrity is maintained and strengthened and that their agencies' progress must be reported regularly. OMB is also revising its instructions to agencies to require budget information sufficient to ensure necessary resources to correct high risk weaknesses. (page 281)

l. *Presidential Priority Systems:* The budget requests nearly $2 billion to design, acquire, and operate program information systems which the Administration has established as Presidential Priority Systems, $402 million more than in 1990. These systems include the Social Security Administration's Information Technology System, Patent and Trademark automation, the Department of the Treasury's tax system modernization, government-wide financial management systems, the General Services Administration's FTS 2000 system, systems under the Department of Transportation's National Airspace Plan, the Integrated Border Information System, the Department of Commerce's Advanced Weather System, and the Securities and Exchange Commission's EDGAR System. (page 282)

m. *Management Support Systems:* The budget requests $558 million for management support systems enhancement, $54 million more than in 1990. These funds will permit continued improvement of financial systems throughout the government so as to provide more accurate and timely information to agency managers and central agencies. The funds will also assist linking these systems electronically in a government-wide network. (page 282)

n. *Credit Management Systems:* The budget requests $860 million for credit management an increase of $58 million over 1990. The Office of Management and Budget and the Department of the Treasury have also upgraded the effort to implement the comprehensive credit management and debt collection program known as the "Nine-Point Program." (page 282)

o. *Pay Reform:* The budget allows agencies to use up to $328 million to begin Federal pay reform. The Administration will seek legislation to authorize geographic differentials for all personnel of up to 8 percent in New York, Los Angeles and San Francisco; 5 percent increases in starting salaries nationwide at GS-5 and GS-7 levels for college entry-level occupations; the extension of current authority to hire at pay levels above the minimum step to all grades; and bonuses to recruit, retain of relocate critical skill workers. The budget will also continue pay demonstrations in the Defense Department, the Federal Aviation Administration and the National Institute of Standards and Technology to demonstrate the effects of pay on recruitment and retention. (page 283)

C. MANAGING BY OBJECTIVES

In *Building a Better America*, President Bush directed the establishment of a Presidential Management by Objectives (MBO) system. Its purpose is to track the implementation of selected major policy initiatives and priorities of the Administration from the time of their formulation and announcement to their ultimate outcomes.

The President approved specific objectives for each of the Cabinet departments and participating agencies, as well as Government-wide cross-cutting objectives, in July 1989. The departments and agencies have prepared strategies for achieving these objectives and have identified milestones for measuring their progress. The budget requests resources for the Presidentially approved objectives within overall spending constraints. The objectives themselves are listed at pages 289–300 of the *Budget*.

The Federal Government Dollar
Fiscal Year 1991 Estimate

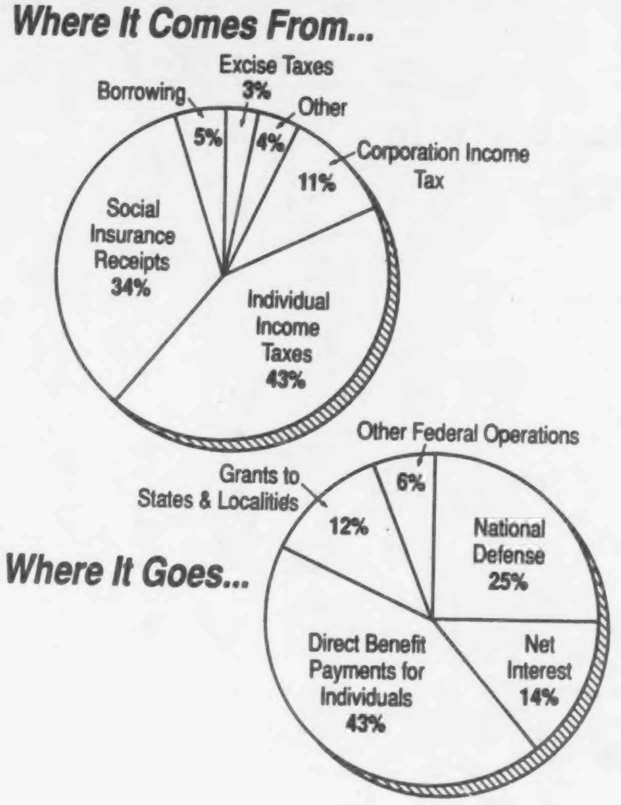


Table 1. **RECEIPTS, OUTLAYS, DEFICIT/SURPLUS UNDER THE PRESIDENT'S PROPOSED POLICY**

(In billions of dollars)

	1989	1990	1991	1992	1993	1994	1995
Receipts	990.7	1,073.5	1,170.2	1,246.4	1,327.6	1,408.6	1,486.3
Outlays	1,142.6	1,197.2	1,233.3	1,271.4	1,321.8	1,398.0	1,476.9
Surplus or Deficit (+/–)	–152.0	–123.8	–63.1	–25.1	+5.7	+10.7	+9.4

Note: Detail may not add to total due to rounding.

Table 2. OUTLAYS BY FUNCTION: 1989–95

(In billions of dollars)

Function	1989 actual	Estimate					
		1990	1991	1992	1993	1994	1995
050 National defense	303.6	296.3	303.3	309.2	311.9	315.7	318.6
(Department of Defense—Military)	(294.9)	(286.8)	(292.1)	(296.9)	(299.0)	(302.3)	(304.8)
(Other)	(8.7)	(9.6)	(11.1)	(12.3)	(12.9)	(13.4)	(13.7)
150 International affairs	9.6	14.6	18.2	19.4	18.8	18.9	19.7
250 General science, space, and technology	12.8	14.1	16.6	19.4	21.4	22.9	24.0
270 Energy	3.7	3.2	3.0	3.1	3.2	3.0	2.6
300 Natural resources and environment	16.2	17.5	18.2	18.9	18.4	18.3	17.8
350 Agriculture	16.9	14.6	14.9	15.6	13.5	11.8	10.4
370 Commerce and housing credit	27.7	22.7	17.2	10.3	9.6	7.7	6.2
(On-budget)	(28.0)	(20.3)	(15.5)	(9.6)	(9.5)	(7.8)	(6.6)
(Off-budget)	(–0.3)	(2.4)	(1.7)	(0.7)	(0.1)	(–0.1)	(–0.4)
400 Transportation	27.6	29.2	29.8	30.2	30.7	31.3	31.3
450 Community and regional development	5.4	8.8	7.8	6.5	6.1	5.9	6.2
500 Education, training, employment, and social services	36.7	37.7	41.0	42.9	43.5	44.1	44.9
550 Health	48.4	57.8	63.7	69.9	75.9	82.0	88.3
570 Medicare	85.0	96.6	98.6	110.1	121.9	135.0	149.1
600 Income security	136.0	146.6	153.7	159.6	166.3	174.6	181.4
650 Social security	232.5	248.5	264.8	280.9	297.7	314.6	331.4
(On-budget)	(5.1)	(3.9)	(4.7)	(5.6)	(6.0)	(6.4)	(6.9)
(Off-budget)	(227.5)	(244.6)	(260.1)	(275.3)	(291.7)	(308.2)	(324.6)
700 Veterans benefits and services	30.1	28.9	30.3	31.0	33.3	32.6	31.7
750 Administration of justice	9.4	10.5	12.6	13.9	14.2	14.3	14.6
800 General government	9.1	10.6	11.3	11.9	25.8	65.2	113.5
900 Net interest	169.1	175.6	173.0	163.5	157.0	147.8	136.1
(On-budget)	(180.5)	(191.2)	(192.9)	(188.1)	(187.1)	(184.1)	(178.9)
(Off-budget)	(–11.4)	(–15.6)	(–19.9)	(–24.6)	(–30.1)	(–36.3)	(–42.8)
920 Allowances:							
Employee health benefits reform			–0.8	–0.9	–1.0	–1.0	–1.1
Reduced Government mail rates			–0.2	–0.2	–0.2	–0.2	–0.2
Total allowances			–1.1	–1.1	–1.2	–1.2	–1.3
950 Undistributed offsetting receipts:							
Employer share, employee retirement:							
On-budget	–29.4	–28.3	–30.1	–30.8	–32.1	–33.9	–35.0
Off-budget	–4.9	–5.6	–6.0	–6.5	–7.1	–7.7	–8.3
Rents and royalties on the Outer Continental Shelf	–2.9	–2.6	–3.0	–3.4	–3.1	–3.3	–3.3
Sale of major assets			–1.3	–1.6	–1.6	–1.6	–1.6
Other undistributed offsetting receipts			–3.3	–1.5	–2.3	–0.1	–1.3
Total undistributed offsetting receipts	–37.2	–36.5	–43.6	–43.8	–46.2	–46.6	–49.5
(On-budget)	(–32.4)	(–30.9)	(–37.6)	(–37.4)	(–39.1)	(–38.9)	(–41.2)
(Off-budget)	(–4.9)	(–5.6)	(–6.0)	(–6.5)	(–7.1)	(–7.7)	(–8.3)
Total outlays	**1,142.6**	**1,197.2**	**1,233.3**	**1,271.4**	**1,321.8**	**1,398.0**	**1,476.9**
(On-budget)	(931.7)	(971.5)	(997.4)	(1,026.5)	(1,067.1)	(1,133.9)	(1,203.8)
(Off-budget)	(210.9)	(225.8)	(236.0)	(244.9)	(254.7)	(264.1)	(273.1)

Note: Detail may not add to total due to rounding.

Table 3. BUDGET AUTHORITY BY FUNCTION: 1989–95

(In billions of dollars)

Function	1989 actual	Estimate					
		1990	1991	1992	1993	1994	1995
050 National defense	299.6	301.6	306.9	312.5	317.5	321.6	325.7
(Department of Defense—Military)	(290.8)	(291.4)	(295.1)	(300.0)	(304.4)	(308.0)	(311.8)
(Other)	(8.7)	(10.3)	(11.7)	(12.6)	(13.1)	(13.6)	(13.9)
150 International affairs	17.3	18.6	20.0	19.6	20.1	20.5	21.6
250 General science, space, and technology	12.9	14.6	17.9	20.8	22.7	24.1	25.0
270 Energy	4.1	5.6	3.3	4.1	4.6	4.4	4.2
300 Natural resources and environment	17.0	17.0	17.6	18.0	17.5	17.2	16.4
350 Agriculture	21.3	18.0	20.1	21.1	18.9	14.9	15.1
370 Commerce and housing credit	61.9	19.6	14.3	13.9	13.8	15.5	14.4
(On-budget)	(60.3)	(15.5)	(11.3)	(11.7)	(12.1)	(13.9)	(13.0)
(Off-budget)	(1.6)	(4.1)	(3.0)	(2.2)	(1.7)	(1.5)	(1.4)
400 Transportation	29.3	31.2	30.3	31.3	31.7	31.7	32.4
450 Community and regional development	7.9	9.0	7.0	6.2	6.2	6.1	6.1
500 Education, training, employment, and social services	38.8	39.6	42.0	42.9	43.7	44.4	45.0
550 Health	51.7	60.3	64.8	70.9	76.8	83.0	89.6
570 Medicare	107.3	116.9	125.2	136.4	150.8	164.9	178.8
600 Income security	173.4	183.2	198.9	204.4	211.9	221.1	227.7
650 Social security	285.0	310.5	345.1	374.0	405.1	438.8	468.7
(On-budget)	(5.1)	(3.9)	(4.7)	(5.6)	(6.0)	(6.4)	(6.9)
(Off-budget)	(279.9)	(306.6)	(340.4)	(368.4)	(399.1)	(432.4)	(461.8)
700 Veterans benefits and services	30.0	30.0	31.0	31.5	32.1	32.8	33.6
750 Administration of justice	10.0	12.2	12.6	13.2	14.2	14.4	14.9
800 General government	10.6	10.5	11.4	11.6	25.7	65.3	113.7
900 Net interest	169.1	175.6	173.0	163.5	157.0	147.8	136.1
(On-budget)	(180.5)	(191.2)	(192.9)	(188.1)	(187.1)	(184.1)	(178.9)
(Off-budget)	(–11.4)	(–15.6)	(–19.9)	(–24.6)	(–30.1)	(–36.3)	(–42.8)
920 Allowances:							
Employee health benefits reform	....	....	–0.8	–0.9	–1.0	–1.0	–1.1
Reduced Government mail rates	....	....	–0.2	–0.2	–0.2	–0.2	–0.2
Total, 920 Allowances	....	....	–1.1	–1.1	–1.2	–1.2	–1.3
950 Undistributed offsetting receipts:							
Employer share, employee retirement:							
On-budget	–29.4	–28.3	–30.1	–30.8	–32.1	–33.9	–35.0
Off-budget	–4.9	–5.6	–6.0	–6.5	–7.1	–7.7	–8.3
Rents and royalties on the Outer Continental Shelf	–2.9	–2.6	–3.0	–3.4	–3.1	–3.3	–3.3
Sale of major assets	....	....	–1.3	–1.6	–1.6	–1.6	–1.6
Other undistributed offsetting receipts	....	....	–3.3	–1.5	–2.3	–0.1	–1.3
Total, 950 Undistributed Offsetting Receipts	–37.2	–36.5	–43.6	–43.8	–46.2	–46.6	–49.5
(On-budget)	(–32.4)	(–30.9)	(–37.6)	(–37.4)	(–39.1)	(–38.9)	(–41.2)
(Off-budget)	(–4.9)	(–5.6)	(–6.0)	(–6.5)	(–7.1)	(–7.7)	(–8.3)
Total Budget Authority	**1,309.9**	**1,337.6**	**1,396.5**	**1,451.1**	**1,522.7**	**1,620.9**	**1,718.1**
(On-budget)	(1,044.6)	(1,048.1)	(1,079.0)	(1,111.6)	(1,159.1)	(1,231.0)	(1,306.0)
(Off-budget)	(265.3)	(289.5)	(317.5)	(339.6)	(363.7)	(389.9)	(412.1)

Note: Detail may not add to total due to rounding.

Table 4. BUDGET AUTHORITY BY AGENCY: 1989–1995

(In billions of dollars)

Department or other unit	1989 actual	Estimate					
		1990	1991	1992	1993	1994	1995
Legislative Branch	2.3	2.2	2.7	2.7	2.7	2.9	2.9
The Judiciary	1.5	1.7	2.1	2.3	2.3	2.4	2.5
Executive Office of the President	0.1	0.3	0.4	0.4	0.4	0.4	0.4
Funds Appropriated to the President	11.0	12.4	12.4	12.7	13.1	13.3	13.9
Agriculture	55.7	55.1	55.3	56.2	55.3	53.4	55.9
Commerce	2.8	3.6	2.5	2.4	2.5	2.4	2.2
Defense—Military	290.8	291.4	295.1	300.0	304.4	308.0	311.8
Defense—Civil	37.2	36.7	38.4	40.1	42.3	44.6	46.7
Education	23.0	24.1	24.6	24.2	24.4	24.5	24.7
Energy	11.7	14.3	14.8	16.9	17.6	17.8	18.0
Health and Human Services—except social security	196.6	212.3	232.4	249.3	270.7	293.5	314.3
Health and Human Services—social security	279.9	306.6	340.4	368.4	399.1	432.4	461.8
Housing and Urban Development	14.3	18.4	23.7	22.2	22.2	21.9	22.1
Interior	5.5	6.2	5.6	5.7	5.7	5.8	5.7
Justice	6.7	8.6	8.9	9.3	9.8	9.8	10.1
Labor	29.9	32.5	32.1	32.3	33.0	33.5	33.9
State	4.1	4.2	5.5	4.7	4.8	4.9	5.1
Transportation	28.5	30.2	29.3	30.3	30.7	30.7	31.3
Treasury	232.1	248.5	256.1	258.9	275.9	316.5	363.2
Veterans Affairs	29.9	29.9	30.9	31.4	32.0	32.7	33.5
Environmental Protection Agency	5.1	5.4	5.4	5.2	5.0	4.4	3.9
General Services Administration	0.2	0.1	*	0.1	0.1	0.1	0.1
National Aeronautics and Space Administration	11.0	12.3	15.2	17.6	19.3	20.3	21.0
Office of Personnel Management	51.2	55.6	58.2	61.3	64.5	68.0	70.8
Small Business Administration	0.4	0.9	0.4	0.5	0.5	0.5	0.6
Other Independent Agencies	67.5	21.3	17.8	19.6	19.6	21.5	20.0
Allowances	....	....	–1.1	–1.1	–1.2	–1.2	–1.3
Undistributed offsetting receipts	–89.2	–97.3	–112.6	–122.5	–133.7	–144.0	–156.8
(On-budget)	(–72.9)	(–76.1)	(–86.8)	(–91.4)	(–96.5)	(–100.0)	(–105.6)
(Off-budget)	(–16.3)	(–21.2)	(–25.9)	(–31.1)	(–37.2)	(–44.0)	(–51.1)
Total budget authority	**1,309.9**	**1,337.6**	**1,396.5**	**1,451.1**	**1,522.7**	**1,620.9**	**1,718.1**

Note: Detail may not add to total due to rounding.

* $50 million or less.

Table 5. OUTLAYS BY AGENCY: 1989–1995

(In billions of dollars)

Department or other unit	1989 actual	Estimate					
		1990	1991	1992	1993	1994	1995
Legislative Branch	2.1	2.3	2.7	2.8	2.7	2.8	2.8
The Judiciary	1.5	1.7	2.0	2.2	2.3	2.4	2.4
Executive Office of the President	0.1	0.2	0.3	0.4	0.4	0.4	0.4
Funds Appropriated to the President	4.3	9.2	12.2	13.2	12.5	12.5	13.3
Agriculture	48.3	48.2	48.7	50.3	48.7	47.8	47.4
Commerce	2.6	3.9	2.8	2.7	2.7	2.6	2.3
Defense—Military	294.9	286.8	292.1	296.9	299.0	302.3	304.8
Defense—Civil	23.5	24.8	25.5	26.6	27.7	28.8	29.9
Education	21.6	22.3	23.7	24.1	24.1	24.3	24.5
Energy	11.4	12.3	13.4	15.7	16.5	17.2	17.7
Health and Human Services—except social security	172.3	191.2	204.1	222.6	241.2	262.9	283.9
Health and Human Services—social security	227.5	244.6	260.1	275.3	291.7	308.2	324.6
Housing and Urban Development	19.7	22.8	23.0	23.9	24.3	25.0	26.1
Interior	5.2	5.8	5.7	5.7	5.8	5.8	5.7
Justice	6.2	6.9	9.0	10.1	9.9	9.7	9.9
Labor	22.7	24.9	26.3	27.0	27.8	28.7	29.8
State	3.7	3.8	4.1	4.3	4.4	4.5	4.6
Transportation	26.6	28.3	28.8	29.1	29.7	30.2	30.2
Treasury	230.6	247.2	254.9	257.7	274.5	315.1	361.9
Veterans Affairs	30.0	28.7	30.1	30.8	33.1	32.5	31.6
Environmental Protection Agency	4.9	5.5	5.8	5.7	5.6	5.4	5.2
General Services Administration	–0.5	0.3	*	0.3	0.3	0.2	0.1
National Aeronautics and Space Administration	11.0	12.0	14.1	16.4	18.1	19.4	20.1
Office of Personnel Management	29.1	33.2	33.6	34.8	37.4	39.8	42.3
Small Business Administration	0.1	1.1	0.3	0.1	0.2	0.3	0.4
Other Independent Agencies	32.5	26.6	23.5	16.4	16.0	14.4	13.3
Allowances	....	....	–1.1	–1.1	–1.2	–1.2	–1.3
Undistributed offsetting receipts	–89.2	–97.3	–112.6	–122.5	–133.7	–144.0	–156.8
(On-budget)	(–72.9)	(–76.1)	(–86.8)	(–91.4)	(–96.5)	(–100.0)	(–105.6)
(Off-budget)	(–16.3)	(–21.2)	(–25.9)	(–31.1)	(–37.2)	(–44.0)	(–51.1)
Total outlays	**1,142.6**	**1,197.2**	**1,233.3**	**1,271.4**	**1,321.8**	**1,398.0**	**1,476.9**

Note: Details may not add to total due to rounding.

* $50 million or less.

Chairman SASSER. Let me say to my colleagues that I am going to have some brief questions, and then I'd like, without objection, to recognize our colleagues in sequence as to when they arrived at the committee for a period of some time. We've tried to recognize them in seniority, Senator Hollings, by way of seniority, but we've seen Senator Robb sit at the end of that table after being the first here for as long as 2½ hours without getting a chance to ask a question. So, without objection, today we'll recognize our colleagues in the order of arrival.

Senator EXON. Reserving the right to object, Mr. Chairman, I've heard that phrase that you just used over and over again, and I have to keep correcting the chairman of the committee, unless I am wrong. When you say you will recognize people in the order of appearance or arrival here, what you really mean is whether or not they were in their chairs when you gaveled the meeting to order.

Chairman SASSER. That's correct——

Senator EXON. Or are you saying if someone gets here 6 o'clock in the morning and sits here, they're recognized first? Do you not mean those that were in their chairs when you gaveled the meeting to order?

Chairman SASSER. Well, that's correct. But anyone who arrives here 2 or 3 hours early, if they'll give me notice, we'll certainly recognize them in advance of anybody else.

Senator EXON. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Exon.

Senator HOLLINGS. I'm here ahead of the next meeting. Go ahead. [Laughter.]

Chairman SASSER. Mr. Darman, two or three quick comments, then I'll get into my questions. You were pointing with pride to the 7 years of, as you characterized it, unparalleled economic growth of the Reagan years. I would simply point out that this is floating on a bubble of $2 trillion of increased indebtedness. And this public debt will increase in fiscal year 1991, according to our figures, by $332 billion. I would observe that with that kind of borrowing you could certainly give an appearance of prosperity for a period of time.

With regard to the military portion of this budget, I note that the administration is advancing a whole series of base closings. Frankly, this doesn't impact on me. None of the bases in my State have been yet looked to for closing. This is strange to me, that we'd be looking at closing military bases before cutting back on the very expensive weapons systems.

I think as you know, I'm also chairman of the Military Construction Subcommittee, and we had some base closings last year. And what we have determined is that you don't save any money from closing bases in the short term. The last round of base closings, which were almost all domestic, increased our outlays or costs $500 million, or will cost $500 million for this year, and $916 million for next year. This is for the base closings that we got into last year.

Now, I noted when you were being queried on this matter by Congresswoman Barbara Boxer yesterday that you agreed with the Congresswoman, and I wrote down what you said. "I agree with you the proportion of savings from base closings is small."

Now, I wonder why we would go down the path of once again closing very large numbers or attempting to close very large numbers of military bases here in the continental United States rather than trying to make savings by cutting back on some of the highly expensive weapons systems that do not have a constituency out there yet to such as the B-2, the rail-mobile MX, a whole series of weapons systems. And I think you might make the analogy here that cutting the bases first would be analogous to perhaps a surgeon engaging in an amputation making the incision before giving anesthesia.

What is the administration's motive for moving first with the base closings before making other substantial defense cuts?

Mr. **Darman**. Senator, the administration, of course, does propose other substantial defense cuts—perhaps we could talk about that later if you wish—and the base closings are in addition to those. It's not insignificant to propose to deactivate two full divisions immediately and more over time.

As you know, there's a rather long list of procurement items and systems proposed for outright termination, and the base closings are another part of this overall decrease in real activity or real product for defense.

You're correct it's a smaller piece in terms of dollars saved. You're correct that the savings tend to rise in the future and that there can in some cases even be increases in expense in the short term. But that doesn't mean that we shouldn't do what we think is right in the short term because the benefits don't come until the long term.

The reason that I believe that Secretary Cheney has proposed the specific base closings at this time is that, as you know, under the law he does not, in fact, have the authority simply to shut them down. And he is obliged to go through a process, obliged by law, that involves notification first and notification at this time, or else he forgoes the opportunity to close those bases. That's the legal requirement.

So the notification is made at this time in anticipation of a substantial future troop reduction, and it would seem to be foolish not to plan for that reduction in the context where everyone assumes that at least some reduction is going to take place.

Finally, with respect to the major systems you referred to, B-2, rail-mobile MX, I would note simply that all of the strategic systems, it seems to me, should be handled not as a budgetary matter in the first instance, since we're in the process of negotiating with the Soviets what we hope will be an equitable and verifiable system of reduction rather than a unilateral one. So if that negotiation is successful, there would presumably be additional savings in the future. But I think most would agree that it would be imprudent to unilaterally take several of these systems off the table. It just doesn't strike me and I think it wouldn't strike most reasonable people as a way to negotiate. If you don't really mean to negotiate seriously, you probably ought to say why not drop out of the negotiations altogether. And we're not about to propose that.

Chairman **Sasser**. My time has expired. Senator Domenici.

Senator DOMENICI. Mr. Chairman, I have a call that I must make, and I think Senator Symms was here. I'd yield the first round to Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman, and, Senator Domenici, I appreciate your yielding.

Mr. Darman, it's a pleasure to have you here. I think you deserve high marks personally for the budget plan that you presented last year, and I think it's worked out pretty well. And I hope you do have as much success this year. I have a couple of questions I want to ask you, but before I do that, I would like to just make a couple of observations for a brief moment or two.

The first one Senator Domenici alluded to, and that is the question of our defense spending and how much we apply to security assistance to some of our friends around the world. It seems to me, in view of what happened yesterday in the media, with the rumor flying around the world that Mr. Gorbachev had resigned as leader of the Communist Party, it is very obvious that there's a lot of volatility behind the Iron Curtain, in the Soviet empire itself, and in the Eastern European region of the world. It seems to me that it would be foolish for this Congress to reduce the defense section of the budget any further than President Bush has asked for. So I would hope that you as the Budget Director, and the administration, would be very firm on this point just as a matter of common sense.

You've made enough cuts. I think those are risky enough. It would be foolish for this Congress to go lower than that, not knowing what is going to happen. There will always be time in the future for further reductions in expenditures for the protection of peace and freedom.

On a more specific issue, I've been told right while we're here that Soviet-made Migs are bombing Jamba, Angola, and that Jonas Savimbi is under great attack. The President had made it very clear in his early remarks last year, he's personally stated, that his administration would support Mr. Savimbi, yet I've been contacted by UNITA and they tell me they get very little, if any, supplies. Yet they're under serious siege right now from Soviet-built Migs bombing the home city of Free Angola in Jamba.

Now, does this budget have money in it earmarked for the support of these freedom fighters in Angola?

Mr. DARMAN. I should just note before answering that I don't have the report that you're referring to about today's action. I'm not questioning it; I'm just saying that I'm not in a position to comment on that portion of what you said.

What we have done is we have provided amounts for all of the accounts in the 150 function, but we have not broken it out yet by country. That's going to be presented—and, of course, that doesn't relate to today's events. It relates to fiscal year 1991. That's going to be presented, I believe, in a few days by Secretary Baker. The final decisions on the country-by-country allocations have not been made. We have made the distribution by line item in the budget, but the country detail is not settled upon yet.

Senator SYMMS. Thank you. The second question I'd like to ask you, Mr. Darman, involved social security. I think we do need to air it out. I'm getting some calls in my district offices in the State;

one of the calls is accusing your plan of doing nothing with respect to social security. If I can quote it correctly, my district office in Pocatello yesterday received two or three calls from constituents that are accusing the "Darman plan", as they call it, to buy Treasury bonds with the social security surplus, as an embezzlement of the social security funds. So I think that there may be a big misunderstanding of what you are advocating doing, as opposed to Senator Moynihan's and Senator Kasten's proposals. I have a plan of my own that I think would be better, which would be to establish savings accounts for individual Americans so they own them, not the government. But that's another issue.

But would you explain to us again how you plan to capture the Social Security Trust Fund and use it to meet the Gramm-Rudman-Hollings targets for the next 3 years? And how are those Treasury bonds going to be cashed in for real goods and services when the time comes the baby boomers retirement? Please explain this so I can have a better answer to tell my constituents as to what this plan is all about.

Mr. DARMAN. Well, first of all, if I understand your constituents' concern, it is that nonsocial security taxes would be used to buy Treasury bonds?

Senator SYMMS. Yes; which is done now.

Mr. DARMAN. Right. That's what the law requires, although it doesn't——

Senator SYMMS. Except we're spending the money now on other things.

Mr. DARMAN. Would you like me to continue? What the law requires is that they be "invested in Treasurys," but it's a bookkeeping transaction. It's not a cash transaction in the marketplace. The government owes itself money in the amount of the receipts from nonsocial security taxes in a given year over the expenditures, plus interest. It's a government obligation to a government trust fund. And the law requires that that be a full faith and credit U.S. Treasury obligation in the trust fund. But it's not held by private individuals, and it isn't, in fact, a cash transaction.

That's why it's possible to have cash available for use in other ways without additional borrowing from the private market. And it's for that reason and because in the consolidated budget and in the Gramm-Rudman accounting we include the annual social security operating surplus, that we mask the true size of the nonsocial security deficit.

To the extent that we mask the true size of the nonsocial security deficit, we may mislead ourselves about our actual financial condition and be inclined to spend more and then borrow more than we otherwise would have done. To that extent, the problem becomes that we build up debt held by the public. That is not the same as the debt in the Social Security Trust Fund. The debt held by the public is Treasury debt sold to the public in exchange explicitly for cash, and it has to be paid back explicitly with cash.

Now, when the baby boom generation retires, if we want to be able to pay what we owe morally to the retiring baby boomers who will have paid into social security, if in the future we want to be able to pay those bills which are obligations being reserved in the form of Treasurys, so they're in that sense the best obligation we can make, full faith and credit of the U.S. Government, we're going to have to turn around at that time and find the cash, as your question suggests. And we can do that through additional borrowing at that time or additional taxing.

But since we've already done the taxing along the way, it's likely that the system would prefer to do additional borrowing at that time. If you want to do the additional borrowing at that time without threatening the governmental and economic financial system of that future, the debt burden that you have of debt held by the public has to be within reasonable bounds. Now, we could argue about what's reasonable bounds, but what we're saying is that the way we're going now is not reasonable because we're piling up too much of that debt, debt held by the public.

So if you want to get that debt coming down, debt held by the public, you have to run the equivalent of budget surpluses. It's the only way you can do it. On a cash basis. What our proposal does is it says—this will take two, three, four more sentences, Mr. Chairman. It says honor the 1983 commitment to social security—the bipartisan rescue plan as it was called at the time—continue to let those trust funds build up, continue the exact same system and obligations we have at the moment, basically don't change the social security side of the balance sheet, leave that as it is. But, meanwhile, change our accounting system so that we more accurately reflect what's going on, and we get ourselves to balance the social security part of the budget, and we start actually buying down debt in the amount of the annual operating surplus coming in for social security. It's not as if that money is being diverted. It's a mathematical phenomenon, say in the amount of that surplus we will let debt expire or go into the private marketplace and buy it down. So that pattern of rising debt that Chairman Sasser referred to and lamented in his opening comments, that pattern is reversed.

Senator SYMMS. Thank you very much, Mr. Chairman. I see my time has expired.

Mr. Darman, as a friend, let me urge you to try to get a simpler answer for the public so that you can have the President not have to face this charge in 1992.

Chairman SASSER. Thank you very much, Senator Symms.

Senator Johnston.

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Darman, this is my 14th budget cycle. I've seen directors come and go. They all defend the budget, some ingenuously, some disingenuously; some even write mea culpas, burdened with a bad conscience after they leave. I don't expect you to do that, although it would be a very readable thing, I'm sure, if you would write it. [Laughter.]

We have seen a change in the budget process. Fourteen years ago, it was a very serious process. Today, it seems to be more role-playing and people posturing and staking out positions. I'm sure you would be prepared to say that the Congress is not entitled to throw the first stone in that respect. And I don't ask you to defend your role in it. But there's one thing I have found out after 14 years of this business, is that there's very little advantage, it seems to me, in deadlock for either the White House or the Congress.

And, indeed, the last few years I have counseled in our party that we try to work it out.

I was a member of the Economic Summit the last couple of years of the Reagan administration. We worked it out. We got a budget. We came in on time the next year by October 1 with all the appropriation bills. I don't know that either party got any advantage from that, but the country did get an advantage from it. I'm sure it comes as no surprise or shock to you to say that the Congress, at least the Democratic part of the Congress, does not regard this as a serious budget. Whether properly or improperly, I don't ask you to defend that because I know you have a lot of answers, and we've heard them all and we've got responses to them.

But my question really is: When do we get down to the serious business of getting together with the White House on a plan? Senator Domenici and I introduced legislation to require that that be done early on in the process. I won't go through all the details of that. Maybe you've seen it. But it seems to me that we're headed for deadlock which can be resolved only at the time of sequestration. I'm asking about the process. When do we get together on this budget?

Mr. DARMAN. Thank you, Senator Johnston.

For our part, we'll be prepared to start 10 o'clock tonight after the President's speech, and say we've finished the first round here, everybody has had his or her shot, and now let's get down to the more serious work. So, for our part, we'd be delighted. I have read through the press—although I must say I've never encountered this in person—that there are some who don't wish to get down to work with the administration. But for the administration's part, we'd be delighted to negotiate starting whenever everybody is ready.

Senator JOHNSTON. Well, now, last year you were saying more than just, you know, we're ready to meet. Last year you were saying let's meet, we want to meet.

Mr. DARMAN. The reason that we're not explicitly saying that—I'd be happy to if it would make it easier—is that a couple of very important people have said that they didn't want to negotiate. And we don't want to prematurely get a no. I mean, when people are ready, presumably they won't say through the press that they don't want to negotiate, and then we'll be able to negotiate.

Senator JOHNSTON. Well, I guess——

Mr. DARMAN. I'd be happy, sir—I'd even say let's not wait until 10 tonight. I know that we have to continue this hearing, but I wouldn't mind starting now.

Senator JOHNSTON. Well, I would say to both parties, we'd better get started because there is no advantage in deadlock, and we're headed for deadlock.

Mr. DARMAN. We agree with you. Could I say, sir, one other thing, though, if you'd allow me to express one small degree of frustration? I realize that I will hear from many people that this is not a serious budget. And naturally you would understand that I believe it is defensible as a responsible budget.

Put that aside, if you would, just for a second. My frustration is that I have, in fact, been through hours and hours and hours—they add up to a very large number of hours—of meetings. You might not call them negotiations, but meetings with people who criticize our nonseriousness, and I have yet to see on the table a plan that I think would pass your test, which would probably be not unlike my test of seriousness, a detailed plan, a detailed plan that has—

Senator **Johnston**. Well, in the Congress, you understand well, that speaks with so many different voices, we cannot present a plan. We have to meet collectively.

Mr. **Darman**. Well, we're prepared to do——

Senator **Johnston**. Let me ask you one more question. If this social security plan is such a good one, why do you want to wait until 1993 to put it into operation?

Mr. **Darman**. We'd be willing to discuss alternatives, more rapid phasing in. The reason that we set it the way we did is based on how fast we think the political system is likely to be able to go to actually get to where you could start buying down some debt. And if we can get there sooner, then we're in a whole lot better shape than the conversations until this point have suggested. But if we can get there sooner, we're certainly prepared to change the phasing.

The way in which we——

Senator **Johnston**. Let me make one more comment because my time is just about up. I would commend for your reading—maybe you've seen the statement by former Secretary Schlesinger today, another article in the Post where the Soviets are quoted on SDI saying that any effort to break the ABM Treaty is going to unravel the whole process; and also former Admiral Crowe, the Chairman of the Joint Chiefs, who stated that the SDI research program should be funded at no more than $3 billion and he goes on to say why. These, among other things, are part of the reason why at least I don't regard this as a serious budget. You've got an increase in defense, nominal to be sure, when peace has broken out all over the world and, as Secretary Schlesinger says, "Warsaw Pact is no more, and all the king's horses and all the king's men couldn't put it together again." We've got an increase in defense. I mean, what kind of serious budget is that?

Thank you, Mr. Chairman.

Mr. **Darman**. Could I respond, Mr. Chairman?

Chairman **Sasser**. Well, do you need a response to that question, Senator Johnston?

Senator **Lautenberg**. If he doesn't, I'd like it.

Chairman **Sasser**. I think that was more of a rhetorical statement than a question.

Mr. **Darman**. No; that's fine. I'll trust that it might arise again.

Chairman **Sasser**. I suspect it will. [Laughter.]

Senator **Rudman**. According to my list here, we've got Rudman—Senator Grassley?

Senator **Grassley**. I thought I was here first.

Chairman **Sasser**. We're going by order of attendance. According to my list, they've got Rudman here first. But if Senator Grassley arrived——

Senator **Grassley**. I would suggest that Senator Rudman can go. If I could just be done by 11:30, I'd appreciate it.

Senator **Domenici**. Senator Rudman, I would yield to him.

Chairman **Sasser**. Are you going to yield to Senator Rudman?

Senator DOMENICI. Yes.

Chairman SASSER. Or are you going to yield to Senator Grassley?

Senator DOMENICI. No, let's go with Rudman.

Chairman SASSER. Senator Rudman.

Senator RUDMAN. Yes, I'll be brief, Mr. Chairman. Thank you.

Mr. Darman, the discussion over the last several weeks regarding social security is really very confusing to most Americans, and your last answer, I don't think, particularly helped. But that's because it's a very difficult issue. Let me see if I can just frame a question and tell me whether I'm right or wrong about this.

Irrespective of whether the debt is going to be held as a special social security debt or by the public at large, the fact is that the bottom line debt of the United States is the figure that counts in terms of interest rates and borrowing. It is the bottom line; it is the total liability that we have. For all intents and purposes, either we owe it or we don't owe it. Is that true or false?

Mr. DARMAN. The last part is certainly true, that either we owe it or we don't. [Laughter.]

Senator RUDMAN. I asked that so I'd at least get one yes answer, Mr. Darman. We do owe it. That's the point.

Mr. DARMAN. It so happens we do.

Senator RUDMAN. We owe it in different ways.

Mr. DARMAN. We do.

Senator RUDMAN. Is that your answer?

Mr. DARMAN. Yes, we do.

Senator RUDMAN. OK. All right.

Mr. DARMAN. But one small further point. Looking for the long term, it's appropriate to look at both kinds of debt, the kind held by the public and the kind we owe to ourselves.

Senator RUDMAN. Oh, I understand.

Mr. DARMAN. The question of interest there is how big is that as a percent of GNP and what does it look like over time. You referred to what determines interest rates. Interest rates are likely more to be determined by the question of how much additional debt held by the public you're going into the market for at a particular time, although for long rates the markets will certainly be looking at the total volume of debt, both kinds. That's the small difference.

Senator RUDMAN. All right. That's very clear. I'll make one point that ought to be made. I had a talk with a group of constituents about this whole issue because the issue has become, you know, quite interesting since Senator Moynihan's proposal. People don't really understand that when the money comes in, when the Secretary of Treasury gets $10 billion on his desk this morning of social security receipts, he doesn't have any options, thankfully. He has to invest them in U.S. Treasury. That's the law. Am I correct? No choice.

Mr. DARMAN. That's right.

Senator RUDMAN. I'm glad it is that way. Four years ago, given an option, he might have invested them in S&L's. The bottom line is that the Secretary of the Treasury can't take the money and bury it. He's got to invest it. It becomes a debt of the U.S. Government, and everybody ought to understand that. With all due respect to masking the deficit, the fact is it becomes an obligation of the U.S. Government no matter how you count it. There is an issue as to whether you segregate the trust fund so the public understands what the surplus is. Senator Hollings has been talking about this for several years, long before Senator Moynihan did. Let me remind everyone, however, that we all understood when we did Gramm-Rudman-Hollings that for macro-economic purposes, it is the total amount of tax that's coming from the American people that is relevant. The fact is that many of my constituents in New Hampshire pay more in social security taxes than they do in income taxes. The point is that, from a macro-economic approach, one should look at total federal income versus outgo. Is that an accurate statement?

Mr. DARMAN. Let's say yes. [Laughter.]

Senator RUDMAN. Finally, I just want to ask you one last question. I just want to get that clear. I mean, people don't understand that this is a debt of the Government no matter how you count it. But where I come from, if you owe it, you owe it. That's pretty basic.

Last question, and this is truly a question. How do you come out with projections? I know Chairman Boskin says that the forecast is conditional on our adoption of this budget. That is really artful. I've got to compliment Mr. Boskin. But I don't accept it.

How do you come out with a T-bill projection for 1991 at 5.4 percent and a real GNP growth of 3.2 percent? I can't find any economist, Mr. Darman, that agrees with that under any scenario for the next 12 months. If you're wrong about that, we're going to have a sequester next fall that's going to make this sequester look like child's play.

So my question is: How do we deal with that kind of projection? You know, I don't doubt your intentions. You must have a basis for it. But I can't find anyone amongst my private economist friends who agrees with those two numbers.

Mr. DARMAN. Well, first of all, as you know from comments I made perhaps to excess last year, I do not have confidence in macroeconomic science as a science. The administration put out a forecast in midsession, the first full forecast. Chairman Boskin had a major role, the dominant role I would say, in determining the shape of that forecast. You can't have the position I have intellectually and argue that you really have claim to start moving things a tenth of a point here or there. I don't believe the science is that refined.

Now, we have not really changed this forecast from midsession. We changed it very, very slightly from midsession. And I might remind you and your colleagues that when our midsession forecast came out in July, it was said to be too rosy. If you would allow me, let me just quickly cite how our midsession forecast—we've only been at it 6 months—has done, and I don't claim this is because we're wise. It can be partly that, and I'll give credit to Boskin, and the remainder I'll give credit to Brady and the rest.

But real GNP we forecast 2.9, came in at 2.9. Unemployment, we forecast 5.2, came in at 5.2. Ten-year Treasurys 8.5, came in at 8.5. Three-month bills at 8.0, came in at 8.1. CPI 5.0—now when we did that everybody said how can you have all this other stuff, how can you have real growth going up and the CPI going down? The CPI can't possibly go down like that or the interest rates can't go down like that. The CPI 5.0, actual 4.8. Below us. GNP deflator 4.5, actual 4.1.

Now, let me note one curious thing about this. People like to use the Blue Chip forecasters as a reference point. There are 52 of them. This is the best forecast of all 52. There isn't one of the 52 that is more accurate than this forecast has proved to be so far. Now, that does not mean that it will be right in the future. I do not have a great deal of confidence that it will be right in the future, or wrong. I think the science is fallible. But we're in a position where for the first 6 months' worth of this forecast we happen to have been right on the button. So I think we deserve some trace of benefit of the doubt for the forecast that is simply an extension of this same forecast.

Senator **Rudman**. Well, I thank you——

Mr. **Darman**. We, in fact, I may say, also predicted the soft fourth quarter. That's part of our original forecast, and we suggested there would be a rebound in this first quarter that we're in now—which, of course, is still well ahead of the fiscal year we're talking about—and we're beginning to see that, too.

Again, I'm not promising we're going to be right, but I'm just saying so far this is more successful as a forecast than any in the last decade.

Senator **Rudman**. Well, I would submit to you that's accurate. I'm aware of that. But I would say, that undoubtedly there are signs in this economy today that were not there at the time that that forecast was made. The real problem I have is with the GNP growth and the 3-month T-bill, those two numbers. I can't find anyone that is even close. I mean, we're not talking tenths. We're talking people who are way off. Whereas, on the last one they were much closer. That's my concern.

Chairman **Sasser**. Thank you very much.

Mr. **Darman**. One last comment?

Chairman **Sasser**. Well, I think you've answered that in great detail, Mr. Darman.

Just let me say this: What we see, it appears to me, are these unrealistic economic assumptions as OMB puts its budget together at the beginning of the year. And then we get the midterm revisions where we move to realistic budget assumptions or economic assumptions, as you have catalogued there, and then it makes it much more difficult for we in the Congress to hit the targets and avoid the sequester. OMB puts their budget together under the rosy economic scenario. Then we come along and have to avoid sequester by using your midterm economic projections which are more realistic, which puts a much heavier burden on the Congress, I would say to my colleagues.

Senator Exon?

Senator **Exon**. Mr. Chairman, thank you very much.

Welcome, Mr. Darman.

Mr. **Darman**. Thank you, Senator.

Senator **Exon**. Let me follow up a little bit on this matter of projections. Last November when we left here, your office certified to the fact that we had had a $100 billion deficit at the end of the year. Sixty days later, that mysteriously rose to $120 billion by your evaluation and to $138 billion by CBO. How did that happen?

Mr. Darman. I don't know what you're talking about, Senator, when you say we——

Senator Exon. I'm talking about the difference between what you said was the end-of-the-year deficit and——

Mr. Darman. I didn't say that, sir.

Senator Exon [continuing]. What it was 60 days later. Well, what did you say it was?

Mr. Darman. Let me clarify. First of all, I don't know what certification you're talking about, $100 billion. I am unaware of——

Senator Exon. Meeting the Gramm-Rudman targets. Isn't that what we did?

Mr. Darman. Well, that is not what we certified. First of all, we had no obligation to certify under the law. Second of all, the target for Gramm-Rudman purposes was $110 billion not $100 billion at that stage of the game. But we were already past it. In November——

Senator Exon. Was that realistic at the time, then, or not?

Mr. Darman. At the time that the reconciliation bill passed, I said I thought the deficit would come in at $120 to $130 billion, and our current forecast is $124 billion. It hasn't moved since what I said in November.

Now, what the administration was obliged to do in the way of scoring back for October 1 and October 15 was—this is by law, and the law has its faults—we were obliged to use the exact same economic and technical assumptions as we had put forward in July, technical assumptions included. There had been changes, and we could not, by law, reflect those changes in the data that we provided to the Congress about where we stood in applying the Gramm-Rudman formula. But when I was asked what do I think the true deficit is going to be, not the Gramm-Rudman projection, I said $120 to $130 billion. I don't to this moment say that I'm confident that's right. But our estimate today is $124 billion. What I said in November was $120 to $130 billion.

Senator Exon. But then when we left here last November patting ourselves on the back that we had met the Gramm-Rudman targets, you didn't think we had.

Mr. Darman. Right, and I said so. I said we had met the bipartisan budget agreement target for deficit reduction. That was the $14 billion, and even some of that was questionable. But we did meet the bipartisan budget agreement target for deficit reduction. I did not say that we were going to meet the actual Gramm-Rudman $110 billion target. I said around $120 to $130 billion.

Senator Exon. Maybe you can tell me this, Mr. Darman, in some fewer words so I can get a bunch of other questions in if I might.

Over the last 10 years, the deficit accumulation each and every year has totaled $1.6 trillion, and yet during that same time we have gone up from $1 trillion to about $3 trillion in the national debt. So if you accumulate all of the deficit at the end of each and every year, you find out that our total debt is about $500 billion over that. Is that essentially because we are using trust funds to offset the difference?

Mr. Darman. Yes.

Senator **Exon**. So then to start out with, we should recognize that we are masking with the present talk about $500 billion of what we owe.

Mr. **Darman**. And rising. But I would note, Senator—and I'll be brief—we are all doing it in accordance with the law.

Senator **Exon**. Well, it's a very confusing law, isn't it?

Mr. **Darman**. It is.

Senator **Exon**. Let's turn to this defense matter. I for one am a little bit weary about hearing all of this talk—it sells well in the newspapers and television because they like to hear about it—about these magical cuts of B-2 and star wars. Now, let me relieve all of my colleagues here. As the chairman of jurisdiction over in Armed Services, I can tell you that there's going to be a billion dollar savings right off the top on the SDI numbers that have been recommended by the administration. That should solve some of the concerns here. We're going to make some reduction in some of the other strategic programs.

The problem with all of this hoopla is that evidently those who are making these claims do not seem to understand that only 15 percent of the total defense budget are in strategic programs. That's SDI, B-2 and all the rest of them. I haven't heard anybody yet say that in the face of the Soviet Union increasing their nuclear deterrent that we should be significantly decreasing. But we are going to be cutting back.

Let me ask you this question, looking into the future. Is it not being studied right now in the Pentagon the idea of cutting back substantially on the buy of the proposed 132 B-2 bombers?

Mr. **Darman**. I can't speak to what the Pentagon is studying internally at the moment, sir.

Senator **Exon**. Have you ever heard about that proposal?

Mr. **Darman**. I know from experience, having worked at the Pentagon in the early 1970's and working with them from where I do now, that they do contingency analysis of a whole range of options for almost everything. And it's a good thing that they do. I mean, that's what you should do for military planning; they also do it for budgeting. So I would assume that there is such an analysis.

Senator **Exon**. All right. If we're talking about seriously cutting the budget, why have we left the U.S. Navy off scot free? The facts of the matter are that most of the cutbacks that the Soviets are proposing are in conventional forces and not nuclear forces. And too few people seem to understand that.

But if we're going to cut back on some of our conventional forces, why is it that the 14 carrier groups of the U.S. Navy weren't touched at a time when we're trying to reduce conventional forces?

Mr. **Darman**. Actually, as you may recall—in fact, you probably know better than I do—in President Reagan's period, we made a great deal of the 600-ship navy, and was moving toward it.

Senator **Exon**. You cut a total of five from—I believe from 553 to 547. So that's not a very significant move down to a 500-ship navy.

Mr. **Darman**. But the plan has changed, I think you could say radically, from a 600-ship navy now moving toward something more like a 500-ship navy.

Senator **Exon**. Creeping towards a 500-ship navy.

Mr. **Darman**. Well, the directional shift is significant, though.

Senator **Exon**. Thank you, Mr. Darman.

My time is up, Mr. Chairman.

Chairman **Sasser**. Thank you very much, Senator Exon.

Senator Domenici.

Senator **Exon**. Senator Grassley.

Senator **Grassley**. Mr. Darman, my questions are meant to be oriented towards management and not towards policy, and they come directly from on page 289, your statement in the document about management by objectives. And since OMB is part of that framework, I'd like to raise a couple concerns about managing and budgeting. As you know, throwing money at problems often exacerbates the problem that it's intended to correct, and we found that out, of course, during the last administration with the defense buildup. Of course, I know the department heads are responsible for the success of their own management initiatives, but OMB serves an oversight function in regard to that.

Last July—and I'm sure you'd expect me to raise the defense issue with you—Secretary Cheney issued his defense management review reflecting his management reform approach at DOD. The DOD management by objective framework was reflected in the program planning objectives, the PPO's, and, of course, in the 20-year road map for long-term planning of investment and modernization needs.

Now, when DOD implemented an update on this issue just 2 weeks ago, there was a noticeable absence of PPO process and the 20-year road maps. In fact, these exercises were not done this year because of what I believe and can prove is bureaucratic resistance. Instead of managing by objectives—at least this year, anyway—DOD seems to be managing tensions between the services and within the Department.

Are you aware of this? And if you were inclined, what would you do to help Secretary Cheney defeat the bureaucracy? And this doesn't in any way question the sincerity or the competence of Secretary Cheney, but it does bring out something you know more about than I do—the power of the bureaucracy. But it also brings out a point that I've always made with defense management reform. Regardless of how good a Secretary of Defense is, if the power and prestige of the White House isn't behind it, it isn't apt to be done. So my question.

Mr. **Darman**. Senator, you're right, I believe, that the revised reports have come in from all the departments, including DOD. They were due January 15. They are being reviewed by our staff. I have not yet seen the review, so I don't know about the changes you're talking about in DOD. It's the first I've heard of it, so I can't responsibly comment on it.

Senator **Grassley**. Well, will you look into it?

Mr. **Darman**. Of course, I would. We care an awful lot about making this system work.

I would say this, if I might just add this thought: My prior prejudice would be to give Deputy Secretary Atwood somewhat the benefit of the doubt on this. He has been changing internal management systems, as you know, within DOD very substantially. And most of what I know of what he's done I think has been an improvement, cutting down on unnecessary bureaucratic activity. So while I haven't seen this specific change yet and can't really comment intelligently on it, I would suspect that if there is such a change—and there may well be—that they've got a very good explanation for it.

Senator **Grassley**. OK. A second concern I have involves a new State Department IG report just completed involving our antidrug efforts. You may not be aware of this, but the morning issue of Newsday carried a disturbing report about the administration's war on drugs. As you know, the antidrug program is now one of the fastest-growing parts of our budget, and I'd like to quote from the report just one sentence. It's a very big report, but the war on drugs is being lost, is taking a huge toll on human suffering, and exacting a high price in political instability in several source countries.

This report says, "There's terrible inefficiency and other major structural problems with our international antidrug efforts." And, of course, this is in spite of the fact that just last week William Bennett said that the drug scourge is beginning to end. This IG report is the very first report card measuring the effectiveness of the antidrug efforts by this administration, and this is a major management problem involving a sharply growing portion of our tax dollars. The State Department's antinarcotics bureau is scheduled for another hefty budget increase this year.

Are you aware of the IG report and its implications?

Mr. **Darman**. Yes; Senator, I'm not only aware of it, under a new system we've put in at OMB we have an early warning of these things. We've really increased very substantially our interaction with the Inspectors General, in this case Sherman Funk at State. We knew of that problem in advance. It is a serious problem. Secretary Baker is also well aware of it.

It's inherent in the situation where you've got rapidly rising money, you're dealing with distant countries where the country's own internal accounting systems and some other systems are not exactly what you would like, and where, in some cases, you know in advance that the Government or parts of it may be themselves corrupt in their relationship with the drug traffickers. So you've got a very difficult problem to try to control, but we've been working on trying to improve the management system for that money for the past several months.

Senator **Grassley**. Is the big increase in the budget right now justified until those management problems are taken care of, though?

Mr. **Darman**. Well, that's a judgmental matter, but I believe the answer is yes. The big increase, as you know, is for the Andean region, and I wouldn't be so naive as to suggest that you can put a lot of money into that drug trafficking area of the world and expect that you're not going to ultimately have some embarrassments. There will be some embarrassments. But, on the other hand, if you ask should we nonetheless try, given the importance of interdiction there, I would say the answer is on balance yes.

Chairman **Sasser**. Thank you, Senator Grassley.

Senator Sanford?

Senator **Sanford**. Mr. Darman, I had great pleasure in the speech you made last year, I think it was at the National Press

Club, and I circulated it to my staff and praised it. And I wouldn't want you to comment on my next statement, but I've had to explain to them that I think you're not free to do what you would like to do.

I'd like to ask you several questions, but first say that my chief complaint with the budget and the budget process that I've observed in the several years that I've been here is that it's just not honest. And I don't mean to question the integrity of anybody involved or Congress, but the system itself is not honest. For this reason, most people, most of the public, think that we are reducing the deficit on a regular basis, and that means that we're getting out of debt—which, of course, is not true. We're simply covering up more of the defined deficit.

The other point is that people think social security is somehow being held in trust as an ordinary retirement fund, available to them in due time, and I think that's not an honest statement of the fact.

Now, let me ask you about the increase in the debt limit. What is that figure in this 1991 budget, the debt limit that relates to the debt limitation? What is the debt limit debt increase?

Mr. **Darman**. Can we get that for you in a second? It must be on the order of $300 billion, but——

Senator **Sanford**. Well, that leaves roughly——

Mr. **Darman**. We'll get the exact number in a second.

Senator **Sanford**. Well, that's all right. That leaves roughly $175 billion over and above the estimated $124 billion defined deficit.

Mr. **Darman**. Right. That's how I got it in my head. Assume about $80 billion for social security and another $70 billion for the other trust funds.

Senator **Sanford**. I'd like to submit several questions for the record, including this one. This question is: What makes up that $175 billion? Now, we know it's the social security annual surplus. We know it's the retirement fund's annual surplus. We know it's the interest paid to social security and the other trusts. We know it's the highway surplus. We know it's the airport surplus.

Mr. **Darman**. Exactly.

Senator **Sanford**. Now, there are a number of other things that should add up to that figure, aren't there?

Mr. **Darman**. Exactly. And they're listed in the budget in the table of trust fund inflows, outflows, and surpluses.

Senator **Sanford**. Well, I couldn't quite find it to add it up, and I would appreciate knowing that because I think that's an important part of our explanation to the public.

Mr. **Darman**. Yes, it is.

Senator **Sanford**. Now, you said—quite accurately, I think—that you had to do what you did in defining this deficit and deficit reduction because it's the law.

Mr. **Darman**. Right.

Senator **Sanford**. Now, I agree. The question that wasn't asked: Would you be in favor of changing the law?

Mr. **Darman**. Yes, I would, Senator. Could I add a couple of sentences? I have now looked—you may recall you correctly chastised me politely last time for not yet having read your own bill. I have now done so, and I've read your associated comments. And I agree with a lot of your definition of the problem, and part of your approach to the solution.

In fact, there's an appendix in here which, when I wrote it, I had you in mind though I knew you wouldn't be happy because it doesn't exactly have the Sanford plan in it. It does begin for the first time, even though the law doesn't require us to do it, to represent the budget in the three different ways that GAO wants, and we said, well, suppose we did it the way a State does, as yours is modeled on, some kinds of States' systems. We said let's take what a lot of people think is the best State, the California system, and reconfigure the Federal budget in the California State budget system.

Senator **Sanford**. I thought that was very interesting, and I saw that. And I thank you.

Mr. **Darman**. And it's related to your interest.

Senator **Sanford**. But let me assure you that I don't designate anything a "Sanford plan." I call it "the honest budget plan."

Let me ask you again about social security now, because I think I really worry about this new concept because I don't think it changes much. We talk about buying down the debt, the private debt. We're doing that now because all the money available we are putting there, and were it not available, we'd be borrowing that much more from the public.

Mr. **Darman**. Yes; the key is—though my answer the previous time was already too long. To make it correct, I should have said it will only work if you also have some requirement that you balance the nonsocial security deficit, which, of course, we're not doing at the moment. And if you did do that, then you would be buying down more debt than we are now.

Senator **Sanford**. Well, I hope we can discuss that later on because that sort of convolutes something that I think can be done much more simply and with more assurance that the money will be there in the future.

Now, you worried me with another thing you said, that in the future when the baby boomers who are paying in all this money now in rather excessive payroll taxes for the moment, that you would either retax somebody or borrow money.

Mr. **Darman**. Not that we would. I would not propose to re-tax somebody.

Senator **Sanford**. Well, we'd have to to get the money to pay the——

Mr. **Darman**. Just tax them the way the current law would tax them.

Senator **Sanford**. Surely. But if you've got all these IOU's that we've got to recover, somehow we've got to get new tax money. And, of course, borrowing pushes them off to another generation.

Mr. **Darman**. No, but a healthy economy can afford to borrow. The question is when are you getting to the limit that's imprudent. What we're saying is if we keep going the way we're going—and I think we all agree—it's imprudent.

Senator **Sanford**. I thank you, and I understand your dilemma. I really do hope we can change the law, and I will give you some more questions, if you don't mind.

Mr. **Darman**. I would be happy to, but, Senator, could I just add one quick comment?

Chairman **Sasser** Make it quick because Senator Domenici has got to leave here, Mr. Darman.

Mr. **Darman**. I'll defer to Senator Domenici.

Chairman **Sasser** All right.

Senator **Domenici**. Thank you. I had committed to be at another event for a long, long time, and I must leave in about 3 minutes. One of you will have to take over on this side.

Mr. Darman, two questions. One, with reference to the domestic agenda on expenditures, I assume that before the President approved significant increases and new programs, the total of which causes appropriated accounts to go up 5.5 percent, he had to look into the inventory of old programs and decide what to do to them. Now, I don't want the litany of what you did, but I want just a quick explanation of how you determined that certain of the old programs either ought to be reduced or terminated versus new programs that you assumed the country ought to have.

Mr. **Darman**. First of all, Senator, you're correct. We did reduce a whole lot of domestic programs—we listed all of them in here—in order to take the savings from there and spend them on some other programs. And so it reflects a conscious decision to try to change priorities.

Initially, we looked at whether we could do it with some sort of freeze formula and tried to see what that would do, because it's a whole lot easier. What we found was that——

Senator **Domenici**. It would have been easier politically.

Mr. **Darman**. I think it's easier politically, and it's a great deal easier intellectually and bureaucratically. You basically don't have to waste a whole lot of time. You decide to freeze and you freeze. The trouble is we went and analyzed a whole series of different possible freezes, which is where we started, and we then looked at what are some of the perverse effects. There are things that you want to do, like be able to go to the next stage in the space station; you can't do it. There are a whole lot of things you know you want to do that you can't do, and then there are some other things which people say really aren't working too well which you continue to fund at artificially high levels.

So, unfortunately, we had to do it the hard way. We went through program by program by program by program in the old style way with a budget review, technician to technician, on up the policy chain, little program, big program, every single one of them, 16 zillion hours, and made our choices. I don't say that they're necessarily the right set, but they were arrived at rather laboriously. And there's a different explanation for each decision.

I did do this, Senator, and I'm not saying it's entirely rational, but it made the problem workable. I started out on the side of saying what are some of the investments we'd like to see ourselves make. And you're right, we give a heavy emphasis to R&D and to Head Start and some of the other things I ticked off at the start. I totaled up what I thought the bare minimum, appropriate necessary amount would be for that, and I said I'll take that as a target to go find reductions elsewhere. If we can find more, then we'll go spend more on these. Well, we actually found a little more, so we spent a little more.

Senator DOMENICI. I know most of the answers to my last question, but I think we ought to put them on this record. Those listening ought to know.

Did you participate as a senior staff member in the drafting of the 1983 Social Security Reform and Stabilization Act?

Mr. DARMAN. Yes, I did.

Senator DOMENICI. I believe that Senator Moynihan was on that group, wasn't he?

Mr. DARMAN. He was not only on that group; he was on what we referred to as the secret core negotiating group, of which I was also a part. He was a prime mover.

Senator DOMENICI. Has he ever attested to the fact that he thought you understood it and were one of the prime movers in finding the answers?

Mr. DARMAN. I believe he has several times in speeches and in his books.

Senator DOMENICI. Now, Mr. Darman, after the Commission passed its legislation and it took effect, in fact, as late as 1988, did Senator Moynihan not acknowledge that Gramm-Rudman-Hollings as a law contemplated using the social security reserve as an accounting method to getting to a balance budget in 1993?

Mr. DARMAN. Yes, he did.

Senator DOMENICI. Was it his opinion when he talked about that in 1983, as you recall it, that he thought this was a good approach and that we were going to help the country by continuing down this path?

Mr. DARMAN. Well, in 1983, we didn't have Gramm-Rudman-Hollings——

Senator DOMENICI. 1988.

Mr. DARMAN [continuing]. So he didn't talk about the interaction. But in 1983 he was highly articulate in saying that you couldn't have the kind of system he's now proposing. He said you can't have pay-as-you-go because of the demographics. And as you know, over the years much of his intellectual work in public policy—very good work—has been rooted in demographic analysis. He argued, I believe very correctly, that given the difference in the size of the baby boom generation and the one following it, it would be irresponsible to continue with a pay-as-you-go social security system. That was his line of argument until December 29 of this last year.

Senator DOMENICI. What I'm wondering is: How is the situation now a lie if it was understood then, preached then, advocated as good economic policy? What makes it a lie now?

Mr. DARMAN. Well, I would prefer that we not use that word.

Senator DOMENICI. I'm not using it. It has been used about the program and in justification for reducing social security taxes $55 billion.

Mr. DARMAN. Well, I don't want to be particular with respect to Senator Moynihan. There's an awful lot of, let's say, "us"—I include myself—who have known fully and completely exactly what we're doing, and those among us who are entitled to vote have voted for it. I personally have not had a vote, but I have nonetheless supported these votes. So in that sense, it seems to me kind of peculiar to turn around and call it a lie. It's been straight aboveboard. The people who wrote Gramm-Rudman, some are here—Hollings——

Chairman **Sasser**. Hollings got a divorce from Gramm-Rudman.

Mr. **Darman**. Yes, I know.

Senator **Gramm**. But I didn't forgive him on child care. [Laughter.]

Mr. **Darman**. But when the Gramm-Rudman targets were set, they took into account the near-term need to include the social security operating surplus explicitly, explicitly. It was debated and decided, and if there needs to be any proof of that point, it is in the law itself, which says that social security is off-budget for everything but Gramm-Rudman. And that wasn't an accident. Now, I am not saying it is right or wrong. We do have a bit of a problem that we can fix. But I think characterizing it as somehow deceitful is inappropriate since it was done so consciously. It is in law, it is evident, it is in the public domain.

Senator **Domenici**. Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Domenici.

It is true, though, is it not, Mr. Director, that the 1983 Commission which was chaired by Alan Greenspan, in putting together the proposal for social security, took a worst-case economic scenario. And as you pointed out earlier in your testimony here, you pointed with pride to the unprecedented economic growth that has occurred since 1983. It is true, is it not, that this surplus has grown beyond anybody's expectations considering that you took a worst-case economic scenario so that the system would continue to break even in the future?

Mr. **Darman**. No, sir.

Chairman **Sasser**. If Dr. Greenspan said that, he is in error, then?

Mr. **Darman**. Well, I don't believe that he would have made an error on this. Could I say what I think is correct?

Chairman **Sasser**. I don't think he would, either. Go ahead.

Mr. **Darman**. The social security actuaries do four forecasts. They are known as Alternatives 1, 2a, 2b, and 3. I believe that the forecast used is 2b, which is not the most pessimistic—the most pessimistic is 3. The current 2b actuaries' estimate suggests a surplus over the long term that is not as high as the surplus that was forecast when the 1983 Commission issued its report. In other words, I think when Chairman Greenspan said we used pessimistic assumptions, if that's what he said, he probably meant we used 2b and not 2a, which is correct; but the most pessimistic is 3.

Chairman **Sasser**. He told me he used a worst-case economic scenario in setting up the proposal so it would be solvent in the future.

Mr. **Darman**. He used the second worst-case.

Chairman **Sasser**. Well, maybe he is in error, then.

Mr. **Darman**. Well, I could see why he would call it worst-case. It is not the most optimistic case.

Chairman **Sasser**. Senator Conrad?

Senator **Conrad**. Thank you, Mr. Chairman.

I, too, want to welcome the budget director here.

I read your preamble to the budget that issued what I would describe as a clarion call to slay the deficit dragon, and then I looked to the battle plan, and it says "Stay in the barracks." And some of us, as I have expressed to you before, are ready to march arm-in-arm in this fight, but as I read it, the President is providing no leadership to take this battle to the Congress.

It strikes me that what we have here is a continuation of a policy of debt, deficit and decline. And when we describe the policy, it strikes me as one that is cynical and destructive of the long-term economic strength of this country. It does not deal with the most serious threat to the security of this country, which I believe is our economic vulnerability.

When you were citing the records of this budget, you left out some: record national debt, record debt to foreigners, record borrowing, record interest costs. I guess we just don't want to talk about those records.

You indicated in the preamble—and I quote to you—"At some point, there is an obligation to be serious." And I am really wondering when that point is going to come. I would suggest to you a good place to have started was with the budget plan that the President has put before us, and I would say this plan is a complete failure on that score.

We have had some quote from President Eisenhower, and I would suggest to you a good place to start is taking his advice of 30 years ago. He said, and I quote: "For 8 years in the White House, I believed, and have announced to my associates, that a reduction of American strength in Europe should be initiated as soon as European economies were restored. I believe the time has now come for withdrawing some of those troops."

Now it is 30 years later, and we haven't moved on his advice. I notice as earlier referred to that Schlesinger, who was the head of Central Intelligence and the top defense official under Presidents Nixon and Ford, says that we ought to have radical cuts in Europe in terms of our forces there. He called the troop cut plans there insufficient.

Brzezinski has an article in the Washington Times that was published back in 1987. He also quoted Eisenhower and said—this is Eisenhower's quote—"the stationing of U.S. divisions in Europe had been, at the outset, an emergency measure, not intended to last indefinitely," and that unfortunately, West Europeans had come to expect our forces to remain indefinitely.

My question to you is how do you justify increasing outlays $5 billion when our military adversary is in complete disarray; their allies are in complete disarray; and yet we propose spending more money than last year?

Mr. Darman. Thank you, Senator.

Could I just first read the rest of that little quote? It says, "At some point, there is an obligation to be serious," as you quoted. It goes on to say, "At some point, partisan posturing must yield to the responsibility to govern." I assume we all agree with that, too.

"Sooner or later, the American political system will rise to the responsibility to be serious to complete the job of fiscal policy correction." Then it goes on to say, "It may do this in small steps or large; it cannot do it with sidesteps." That is obviously rhetoric.

But I think what you are saying is we should do it with the large step; that is what——

Senator CONRAD. I'm suggesting we start. I mean, this adds $300 billion, by your own testimony——

Mr. DARMAN. Right.

Senator CONRAD [continuing]. To the gross national debt. That doesn't strike me as even a baby step——

Mr. DARMAN. Right.

Senator CONRAD [continuing]. Or a sideways step. It is a step backwards.

Mr. DARMAN. Well, I was hopeful we were going to do the larger step last year. We did not succeed.

I will always be hopeful we can do the larger step. I'm going to try this year.

Senator CONRAD. But how does it start without Presidential leadership? How does it begin unless you are willing to come forward and the President is willing to come forward and, instead of telling the American people we don't need to do much, to say to them we need to do something.

Mr. DARMAN. Respectfully, sir, you can't have it both ways. You can't say that I'm saying we've got a lot to do, and we're not doing as much as I say we've got to do, and then turn around and say we're not saying we've got a lot to do. We are saying this budget documents more than any budget that has ever come out of the executive branch what the nature of the exposure is and so on. It doesn't say there is no problem here. In fact, one of the reasons I wrote the preface is that I was concerned that we can meet the Gramm-Rudman targets, that we can meet the law here, and this budget is serious by that measure. It is a budget which if enacted would satisfy the obligation of the existing law, and indeed, with continued economic——

Senator CONRAD. Do you honestly believe, sir—I mean, really, do you honestly believe that if this budget were enacted that we would reach a $63 billion deficit?

Mr. DARMAN. No.

Senator CONRAD. I mean, again, I would echo Senator Rudman. I have not found an economist who believes these economic assumptions, and history is not much of a guide here. I mean, if you look to what the economy is doing today, these growth estimates are a dream.

Mr. DARMAN. Well, I have already spoken to that point. I don't want to consume your time trying to repeat the same defense on the question of the economics, although I repeat I do not have confidence in any of the estimates. I note only so far we have been correct, so we ought not to be dismissed altogether.

But on what I would say is your more important point, the seriousness point, all I am trying to suggest to you is that at a minimum, let's try to meet the Gramm-Rudman target for reduction. And I would contend that this is a major step in that direction. But I then go on to try to say that we should not fool ourselves into believing that that is the whole problem. The whole problem is larger. And we can approach the whole problem either by somehow sitting down together and getting a more comprehensive solution, or by keeping going at it every year. Based on my experience last year—and maybe I am a little too defeatist, and I apologize—based on my experience last year, while I'd love to have the big solution, I am concerned right now that we at least get the amount that we've got to have as the bare minimal solution. Frankly, when you start writing this as I did in a political environment where people are talking about yanking $55 billion a year out of the revenue stream—$55 billion, then $80 billion, then $100 billion, then $120 billion—seriously talking about that, which is the exact context in which this is written, it is kind of hard to persuade yourself that the political system is ready to be serious.

I am not saying it isn't ready. I am just trying to explain the state of mind here, that it just so happens that this was written right close to December 29, when everybody was getting enthusiastic about pulling revenue out of the system.

Now, if you say that our true gap—use the economists that you have in mind——

Chairman Sasser. Mr. Darman, if I could interrupt just for one moment, I understand you need to leave here in the not-too-distant future, and we've got a number of Senators who want to ask questions——

Mr. Darman. I apologize. I didn't answer the real question. The real question was——

Chairman Sasser [continuing]. And if you'd watch that red light and try to make your answers a little more succinct, I think we could get you out of here on time.

Mr. Darman. I apologize, Mr. Chairman.

The answer to the specific part of your question which had to do with the defense budget—and I realize that this, too, we could differ about—the answer is this, I believe, succinctly. The true cost of the defense program was not adequately reflected in the current services budget, and was not adequately reflected in the midsession estimate. The true cost of the prior defense program, for this year, had it been funded, was probably going to be—this is for DOD only—about $317 billion in budget authority. So when you come down to our proposed $295 billion, that is a $22 billion cut in budget authority just to get to the $295 billion.

The reason that you don't see even more in the way of a cut has partly to do with the fact that the previously approved program was going to cost a great deal more than noted in the budget.

Chairman Sasser. All right. Thank you very much.

Before turning to Senator Gramm, just let me say before we get into a total revision of history here that the others were hopeful last year that we could take the larger step. I want to make it clear that it was not because of reluctance on the part of the congressional part of that group last year that a larger step was not taken.

Senator Gramm?

Senator Gramm. Mr. Chairman, I'd like to go back and say one thing about social security. I'd like to remind everyone that on the day that we wrote the Gramm-Rudman-Hollings law in its final version, the deficit was $233 billion, and that was a unified budget deficit counting social security; the projected unified budget deficit for fiscal year 1990 was $296 billion. Not only was the law written to clearly count the trust fund; no one ever suggested otherwise.

In fact what has happened is we have been so successful in reducing the unified budget deficit down to $124 billion, with $9 billion of nonrecurring savings and loan cost, that it is now dreamable to balance the budget without counting the Social Security Trust Fund, but to suggest that somehow this progress has been phony and that we have changed the system is just disingenuous.

Now, Mr. Chairman, on Thursday when this budget started to leak and continuing today, we have heard nothing but statements like this is a rosy scenario, this is unrealistic, this is phony, this is fraudulent, this is not serious, this is a complete failure.

Well, Mr. Chairman, I am not here to defend this budget. There is a lot wrong with the budget. But let me set out some facts, and I defy anybody to come up with hard evidence to the contrary.

Number one, this is the most realistic budget that has been submitted by a President in 5 years.

Chairman Sasser. We'll agree to that.

Chairman Gramm. Number two—you are not going to agree with the next one, Mr. Chairman—no budget adopted by Congress in 5 years has been as realistic as this budget.

Secondly, I hear this rosy scenario stuff, and maybe it is, but this budget assumes 2.4 percent real growth in 1990 when the average for the last 7 years has been 3.92 percent. We look at the bad quarter we had, but if you go back to the second quarter of 1986, we had 0.4 percent real growth, and yet CBO projected in the budget for that year a 3.1-percent real growth for 1987 following that bad quarter.

So maybe these are rosy scenarios, maybe they are unrealistic, but they are not as good as the achievement in any one of the last 7 years, and I think somebody would have a hard time in any kind of objective form savaging this budget on a rosy scenario.

This budget has a 5.5 percent increase in discretionary spending. That is hardly a miserly budget. What the budget does propose, however, is reordering priorities.

Now, I submit, Mr. Chairman, that nothing could have been submitted to the Congress that would not have been subject to these criticisms. The problem with this budget in the minds of many of the critics is that it does not represent their priorities. It does not call for a tax increase. If the President through Mr. Darman had submitted a budget calling for a tax increase, it would have been roundly praised as being realistic.

What is unrealistic about this budget is that it reflects the priorities of the President and I believe the American people, not the priorities of many in Congress.

Now, Mr. Chairman, I said all these things because I am deeply concerned that we are changing the budget process into a political ritual. This whole process has stopped having any meaning whatsoever. A budget is submitted that is 1,296 pages long, and before anybody has ever looked at much hard copy, it has already been criticized, savaged, as unrealistic, dead on arrival, dead before arrival, and the plain truth is, with all of its failings, this is a serious budget. And I would be willing to predict right now that this budget is more realistic and is a better budget for the economy than we will adopt, and it is certainly better than the budget that we will enforce.

So I don't have a question. I think it is clear from listening to me that I've made up my mind on the subject. But let me tell you exactly the subject I have made up my mind on. What we are doing here is destroying the process that gives us some vehicle to try to deal with the problem. And I think in the partisanship and the politics of this whole process, we are debasing, number one, some real success that has occurred mostly because of economic growth, not because of us; and secondly, we are convincing the public that the budget process itself is not a serious process. And maybe it has not been used as a serious process, but I think by and large the response we are giving to this budget tells you more about the process than it does about the budget, more about the partisan conflict than it does about the reality of the situation.

There are a lot of things in this budget I don't support, but if it were adopted, there is no doubt interest rates would go down, real GNP would go up, the economy would be stronger and more competitive, and we will not adopt a budget as good as the budget that is in front of us from the point of view of the economy. I make that prediction today with no fear of contradiction whatsoever. I think it is sad, but I think it is true.

Chairman **Sasser**. Well, thank you very much, Senator Gramm. Senator Simon?

Senator **Simon**. I think Senator Wirth was here ahead of me.

Chairman **Sasser**. Senator Wirth and then Senator Simon.

Senator **Wirth**. Thank you very much, Mr. Chairman.

Mr. Darman, this is my 10th year on a budget committee, and after listening to a lot of the discussion, it appears to me that—and first of all let me say I watched last night with interest the reaction on television from a lot of our colleagues in the House—and while I understand some of that, I just want to say I think there are a number of things in the budget that are positive; there are a variety of initiatives on science, there are some initiatives in education, there are a number of initiatives on the environment that are very positive, and I would just like to be on the record to commend the administration for those steps.

Mr. **Darman**. Thank you, Senator.

Senator **Wirth**. Also, as I listen to you today, I am very struck with your intellectual commitment to trying to think long-term about how we might change thinking about the budget—the notion of cash budgeting, the notion of looking at investments in a different way—and I think that is very productive and the sorts of things we ought to be thinking about in truly recasting the way in which we look at the budget.

I think on the margin there are a lot of differences that we can have on estimates or on where there is phony budgeting and so on, and everybody has been guilty one way or another of doing that.

As I look at this budget—and this is the thrust of what I want to talk with you about—as I look at this budget, it seems to me there are two fundamental issues here that are of deep concern, the reason why so many people on my side of the aisle have been concerned about this and are probably causing the flashpoints.

One of those is the amount of borrowing that is going to be required. On the one hand, there is the public document that says that we are getting this down to, I believe, the Gramm-Rudman target of $64 billion, which is to suggest to the public that that is the size and the scope of the debt. I think that is the common assumption that is made out there across the country, that if you get Gramm-Rudman-Hollings down to $64 billion, that's the debt, and you are making progress. Whereas the real deficit, as you pointed out in your answer to a question from Senator Sanford, is closer to $300 billion; that's the amount of borrowing we're going to do. And there is a very large gap between $64 billion and $300 billion. I think what is happening is that a lot of people are looking at that $300 billion and saying, hey, look, you guys are not serious about these numbers—it is really $300 billion, and let's get after the $300 billion. But that is item number one in terms of the frustration of the discussion.

Item two is defense, where we hear Richard Perl who says the cold war is over, and says let's not build the rail-mobile MX and Midgetmen—quite a remarkable testimony—and we listened to Secretary Schlesinger yesterday in the Armed Services Committee, saying we should bring troop levels down very dramatically, and, again, the cold war is over, and we can't expect the Warsaw Pact to be any kind of a threat.

So we look at the defense budget coming in from the administration at $300 billion. The norm since World War II has been about $200 billion—and that's with a cold war since World War II. And I think a lot of people in the Congress and the vast number of people in the public wonder why it is with the end of a cold war that we are still talking about spending $300 billion, when even the norm since World War II is $200 billion. We can do a lot better than that.

So as I listen to all of this today, and read material on the budget, it seems to me that those are the two areas where we have the greatest need for a lot more communication, and if we are ever going to get a budget that is going to work, it's got to be a budget that, I think, does more to be realistic about the size and scope of the deficit and moves in the right direction on defense.

Now, I realize that on defense, there are certain constraints given the negotiations that we are doing and so on, and I understand that. The question that I have relates to the larger step. I guess what I'm talking about is another way of getting at what you call a larger step.

You know, we have to take a larger step to bring down the deficit, measured as the real amount of borrowing the country does. We have to take a larger step, and I suppose a part of that is coming down the line on defense.

How do we go about doing that, and what are the ingredients of a larger step? First you might want to—I don't know if you agree with my assumptions that these are the two major flashpoints in the budget and the ones that deserve the attention; if you agree or not, you might comment on that, and then what are the ingredients of what a larger step might be, and how do we do that, Mr. Darman?

Mr. DARMAN. Thank you, Senator Wirth, and thank you for the positive introductory comments as well; I appreciate them very much.

On the point about borrowing, first of all, as to whether these are two important points of difference, it seems to me the answer is yes——

Senator WIRTH. Do you see any other major important points of difference?

Mr. DARMAN. One other, and we have already talked about it today, is the economic assumptions—although I think our position is——

Senator WIRTH. That's always there.

Mr. DARMAN. Well, this time I think our position is more defensible, but in any case, I am only trying to be complete; I think that is also one.

Let me make a couple quick comments about those before getting to your larger question. On defense, it is I think at least worth nothing that the budget as presented would get defense in the budget year going at minus 2.6, minus 2.0 annually thereafter; would get defense as a share of GNP to the lowest level in 50 years; it would get defense as a share of the Federal budget to the lowest level in 50 years—pre-World War II.

So by those measures, it is not at all out-of-line. And I think that it is at least interesting to note that the settling point from an historical perspective, 5 years out, is probably quite defensible. I think, at the moment, the real debate is probably more about the rate in the first year than it is about the trend and the settling point.

And I would predict to you—this is in the nature of a prediction such as Senator Gramm's, about political behavior—but I believe that although expectations now are for a very much higher peace dividend, that as the Congress examines this in detail, they will discover that they do not in fact want to vote for cuts as deep as some are assuming should be possible in the immediate first year of this adjustment. That is a judgmental matter, and we'll see.

On your point about borrowing, one small point. It won't defuse the current debate, but the problem with this is that both approaches are right; so are others. In other words, the $64 billion or whatever we estimate the consolidated budget deficit to be is a correct measure, roughly, about what we would have to do in the way of cash borrowing today in publicly-funded debt.

The debt that is measured not on a cash basis, but the combination of the cash shortage and other obligations as to the trust funds, the larger number, that is a relevant number also, because that tells us what our future obligation is going to be. They are both relevant.

Chairman SASSER. Mr. Darman, you are talking on your own time now, not Senator Wirth's time.

Mr. DARMAN. I apologize.

Chairman SASSER. I just want to caution you about that.

Mr. DARMAN. I can't look that way and see the red light simultaneously; I apologize.

Senator WIRTH. How to do it—what are the ingredients? It seems to me if we are going to talk about a larger step—I know my time has expired, Mr. Chairman, but——

Mr. DARMAN. You know, Senator, I have to express one small frustration here. I go through this process—and I understand how it works, and I'm not complaining—but here we have a whole bunch of proposals, and we have selective and general criticism of them. And there is nothing in this process here so far—I think Senator Hollings may correct this—but there is nothing so far that puts specific proposals, counterproposals, on the table.

Senator **Wirth**. That wasn't my question, Mr. Darman. My question was when you talk about larger step—you used the term "larger step"—I am just asking you—I am trying to be as conciliatory as I can. You are talking about larger step. What are the ingredients of a larger step? That's not a difficult question.

Mr. **Darman**. I'm expressing as a matter of personal preference a desire that we should be able to work out something larger, in a context where some percentage of your colleagues are talking about going in the opposite direction.

So when you ask me what could be part of a package, such a package has to be negotiated. Such a package is not imposed by the Executive. This here, several of you are just dismissing. Well, most of this would have to be part of the package.

You can't be serious about getting the deficit under control without doing at least half of what is proposed in here for entitlements, and then some. And the same is going to be true for a lot of these discretionary cuts. And the same is going to be true for the credit reforms. It isn't a serious package if we don't include the credit reforms which are proposed in here. And if everybody is going to just dismiss what is right here, it's ridiculous to even talk about a larger step.

Senator **Wirth**. Mr. Darman, I started out by not dismissing it. I just asked you a simple question about what might be the ingredients of a larger step, and I am sorry we didn't get an answer, Mr. Chairman.

Chairman **Sasser**. Well, I'm sorry you did not get one either, Senator Wirth. Maybe somebody else will make a run at it here.

Senator **Wirth**. Thank you.

Chairman **Sasser**. Senator Nickles.

Senator **Nickles**. Mr. Chairman, thank you very much.

Mr. Darman—correct me if I am wrong—but the budget calls for spending $1.23 trillion. That is 1,230 some billion dollars.

Mr. **Darman**. Right, $1,233 billion.

Senator **Nickles**. Is that equal to about $5,340 per person?

Mr. **Darman**. I hadn't calculated it that way, but since you have, I'll assume it is correct, Senator.

Senator **Nickles**. Well, that's my longhand, and I think that's correct, but $5,340 per person seems to me to be a lot of money. So when everybody comes running to you and requests that we spend more money on a variety of subjects, I hope that you are able to keep the total cap on what we spend at this $1.23 trillion and not allow that to grow larger. That would include recommendations for vetoes, and I happen to be on the Appropriations Committee.

Looking at your summary; you estimate the increase in revenues to be 9 percent and increase in expenditures to be 3 percent; is that correct?

Mr. **Darman**. Right.

Senator **Nickles**. The revenue increases without a tax increase, I noticed between 1988 and 1989, revenues increased 9.1 percent, and between 1989 and 1990 estimated, they would increase 8.3 percent. So your revenue estimates are in line with the last couple of years, I guess, if this year comes out correctly.

Mr. **Darman**. We are a little below. Without our new receipt measures, it is 7¾ percent, roughly, but that is because the forecast includes some slowing and then an uptick in the economy.

Senator **Nickles**. OK. Where I am afraid you may be on the optimistic side is, that the last several years, expenditures growth have exceeded 3 percent. Last year, between 1988 and 1989, expenditures grew by $79.6 billion, or 7.5 percent, and estimated growth between 1989 and 1990, at 4.8 percent, and you are calling for 3 percent from 1990 to 1991—so a much slower rate of growth on expenditures. I hope you are successful, but my guess is—if we look a year from now at how close were you on both the expenditure amount and on the revenue amount—my guess is you will be closer on the revenues, and you will be underestimating the expenditures. I hope that is not the case, because I personally think $5,340 for every man, woman and child in the United States is enough.

So I would hope that you would really be stringent in trying to keep those limits on outlays.

Let me ask you a question on the outlays and the baseline. In the OMB baseline, do you include inflation for every, single program?

Mr. **Darman**. We include inflation for all discretionary programs. For mandatory programs, the growth rate is a combination of the inflation element and other factors that have to do with demand for the service, basically.

Senator **Nickles**. The only discretionary account that did not get inflation was defense; is that correct?

Mr. **Darman**. No; there are many domestic discretionary accounts which also went down. They are listed in here in a chapter of their own.

Senator **Nickles**. Let me ask you this. Do you have a baseline budget that does not factor in inflation for discretionary accounts unless mandated by law—because I think your baseline should be without inflation unless it is already mandated by law.

Mr. **Darman**. Well, I can tell you off the top of my head what it would be roughly, but the answer is no. It would be the $100 billion we've got there less probably about $10 billion. It wouldn't change it that much. It would probably be about $90 billion. Let me just doublecheck.

[Mr. Darman conferring with staff.]

Senator **Nickles**. Let me just ask you to do that.

Mr. **Darman**. OK.

Senator **Nickles**. Because I think you should do it for defense, too.

Mr. **Darman**. If we do it for defense, too, it will be about $20 billion. In other words, our baseline, it would be about $80 billion, and CBO's, it would be about $118 billion.

Senator **Nickles**. I was going to say I asked CBO to do the same thing, I asked them to figure out what it is. If you have that, or if your number-crunchers can come up with it, I would appreciate it. I think the baseline should not automatically assume inflation for every account, so we would be working off this year's anticipated level instead of next year's projected, after inflation—I think that is important.

Mr. **Darman**. We agree with you. That is actually one of our budget process reform proposals, but it is not the current law.

Senator **Nickles**. I understand that, but I think it would help. You mentioned having alternative budgets——

Mr. **Darman**. Right.

Senator **Nickles** [continuing]. And Senator Sanford requested—well, it is one of your proposals, and I think it would be very helpful.

Let me ask one other question, and that deals with the Social Security Trust Fund and the discussions that many of us have had.

If you pay off the outside debt, and you end up with the Social Security Trust Fund having, say, $3 or $4 or $5 trillion worth of debt, that debt is still a liability on future taxpayers, is it not?

Mr. **Darman**. Sure.

Senator **Nickles**. Well, I think many have treated it as an asset that is ready to be cashed, but if it is, it will still have to come from the population or maybe other governments would buy it. So even if you paid off the outside debt, the Social Security Trust Fund still has $3 trillion or $4 trillion or $5 trillion worth of T-bills or debt, that is basically nothing but a piece of paper unless it is sold. Therefore the future generations have to pay.

Mr. **Darman**. That's true, but on the other hand it is pretty good paper; it is U.S. Government paper. But the key is to make sure that the U.S. Government, when the bills come due, is every bit as strong as it is today.

Senator **Nickles**. But I am concerned about the liability on future generations, (1) to meet the current payments, and (2) to pay off this enormous debt that is accumulating. I think a lot of people are acting like that is not a liability on future generations, and it certainly is.

Mr. **Darman**. Yes, sir, but could I make one small point?

Chairman **Sasser**. Make it quick.

Mr. **Darman**. If by chance, as with our proposal, you were to get the debt held by the public down to zero, you would save on today's pattern of funding $175 billion a year in cash interest payments. That $175 billion would be available to pay the obligations as they come due for social security beneficiaries in the future, along with the continuing social security revenue stream in the future, in accordance with today's tax schedule, not a higher one.

Senator **Nickles**. What you are really saying, though, is that $175 billion would not be paid outside, so you wouldn't have the cash outlay, but you are going to be crediting $175 billion in interest obligation to the trust fund.

Mr. **Darman**. No; when the baby boom generation retires, you have got to actually pay them cash. That's what we've got to be prepared for.

Chairman **Sasser**. Senator Nickles, let me just say you are not going to get a quick answer to this. We have been through this before. And in defense of Mr. Darman, it is a complicated answer.

Senator Simon.

Senator **Simon**. Thank you.

First, there has been talk about a bipartisan effort here, and I hope we can move in that direction more. What I am concerned about, what I hope we do not do, is a bipartisan ducking of the real problem—and the real problem is the deficit.

Now, I understand that the reason for ducking is campaign pledges made. But as I look at the budget, for example, there is an 11 cents per transaction fee on futures. Now, the futures people in Chicago think that is a tax. And I think most people think that is a tax. And whether we call it a user fee or whatever we want to call it, it is a tax.

If we can do that, is it possible to have a cigarette tax? Is it possible to do some other things that can start to force us to address the deficit?

If you were just to look at this budget, and it were a family budget, I think the conclusion would have to be that this family needs some credit counseling. I think we have to look at where our growth is, where we can cut back, and what our priorities are. And you are getting lectured at, Mr. Darman, more than you are getting questions here, but let me just tick off a few.

Totally aside from what is happening in Eastern Europe, we are still spending three times as much per capita for the defense of Western Europe as the Western Europeans are spending. That's just not rational for the year 1991.

Second, as I look at the budget—and I have to say it is tough in some areas to put two and two together—but it appears that we are cutting back on our commitment to Eastern Europe from 1990. I hope I am wrong on that, and if you can have someone in your operation send me the information, I'd appreciate it.

Third, the President has said that he wants to be the education President. And anyone who looks at where we are has to say we have to do much better. But a request of $400 million, while I recognize that is a substantial amount of money, that is one-thirtieth of 1 percent of the Federal budget. And I compare that $400 million increase that is requested in education with a $2.9 billion increase that is requested for NASA, and I wonder whether the future of this Nation is more at stake in the schools of Chicago and Washington, or more at stake whether we get that flight into space.

I'd like to see—and I hope we can do this before this budget moves out—we'll get social security out of the budget, and that we will do one other thing, and there I want to get into a question or two with you—that we list gross interest. We are just fooling ourselves on the interest expenditure.

Mr. DARMAN. That's a good point.

Senator SIMON. It is the fastest-growing item in the budget by far——

Mr. DARMAN. We do list it, Senator, but it is not highlighted. I understand your point.

Senator SIMON. You are correct, it is not. You really have to hunt to find it. In fact I was just going through the budget here—what is your anticipated gross interest expenditure for fiscal year 1991?

Mr. DARMAN. I'll let Barry get it while you continue.

Senator SIMON. OK—if he can find it.

Mr. DARMAN. We'll give it to you in 1 second.

Senator HOLLINGS. $260 billion.

Senator SIMON. $260 billion?

Senator HOLLINGS. That's gross, 1991.

Senator SIMON. OK. And that $260 billion is premised on a 5.4-percent interest assumption. And I think most economists—and here I recognize these are projections, and we can all be wrong—I think most economists will come up with about 1.8 percent higher than that figure.

Mr. DARMAN. That's true, but of course, you don't refinance all the debt in fiscal year 1991; you've got a lot from the past. The average interest rate doesn't change much in 1 year.

Senator SIMON. I understand. But in any event by far, even assuming your $260 billion figure, fiscal year 1980, the gross interest expenditure was $74 billion. We are talking about just a massive growth. You are correct, it is not highlighted—he can't even find it in that book there.

Let me ask you this question. That 11 cents per transaction on futures, I assume you do not call that a new tax?

Mr. DARMAN. No, I don't, Senator.

Do you want to switch back to your other subject?

Senator SIMON. If you wouldn't mind, yes—and what page is this on?

Mr. DARMAN. It is on A243. Senator Hollings wins the prize for the closest guess—$259,763,485,000 or rounded, $260 billion.

Senator SIMON. OK. And let me just add, you pointed out the reason we ought to get this thing down—we could save $175 billion a year if we got interest rates down. And what that would do to investment in this country is just beyond calculation.

Anyway, how do you describe this 11 cents per transaction for futures?

Mr. DARMAN. It is listed in the receipts section, in a section called "User Fees". There is quite a long list of them. It is one among many. And the definition in that particular case is not being cute; it really is charging the people who are benefitting from a service that is provided for the service that is provided as best it can be estimated.

Senator SIMON. But couldn't we in the same way say cigarettes are costing us how many tens of thousands of lives each year, huge medical costs——

Mr. DARMAN. You could. We haven't done that, but you could. I'm not sure this is going to be a productive debate, because at Senator Bentsen's request, I have dropped the use of the "duck" metaphor, which is what this kind of issue is related to.

If you were using the cigarette tax—and we are not proposing that—and if it were going to be called a user fee by conventional standards, the revenues would have to be dedicated to something that was going to actually benefit the cigarette smokers. That's pretty unlikely.

Chairman SASSER. Senator Simon, I'm going to have to reluctantly advise you your time has expired some time ago, and we've got others waiting here.

Senator SIMON. OK. Thank you, Mr. Chairman.

Chairman SASSER. Senator Kasten?

Senator **Kasten**. Mr. Chairman, thank you.

First of all, I want to associate myself with the remarks of Senator Gramm. I think this is a good budget. I think this is an honest attempt. I think we are moving toward an agreement of some kind, and I am happy to hear what some of the people at the table are saying, at least.

I wish I had in front of me—and I'm going to try to include in my remarks—that column on the "Week in Review" section of the New York Times this Sunday, because it took us through this budget process month-by-month. And we are going through exactly what they said was going to happen in January and February—question the economic assumptions, throw around a little partisan debate, trash it, criticize it, dead-on-arrival, and then you go to the next section, and you kind of work your way all the way through the spring and the summer, ending up with a crisis occurs; and then it is either the debt ceiling extension or something else that kind of forces all this.

And I guess this is my 7th or 8th or 9th year here, and in a way, we kind of go through this little dance, and the New York Times had it outlined pretty well, month by month by month.

Maybe there is a chance that we can start to change that schedule. But I agree with the overall thrust of this budget, and I am hopeful that what we adopt could contain many elements of this budget. I just hope we don't go through the New York Times dance exactly as they have predicted.

In Steve Symms' question and others, we are going back and forth trying to describe the so-called social security issue. I don't think it is hard to explain. I think it is explained by the administration is now proposing to run a surplus in the Social Security Trust Fund that buys Treasury Bonds after 1994 to pay down the national debt——

Mr. **Darman**. That's not accurate, Senator.

Senator **Kasten** [continuing]. Or another way of saying it, in my opinion—and this is a quote from Steven Entin, who used to be at the Treasury Department, and I think he used to work with you—the administration would retain the 1990 OASDI tax rate and the surpluses. After balancing the rest of the budget by 1994——

Mr. **Darman**. That's the key point—after balancing the rest of the budget. That's the key point.

Senator **Kasten** [continuing]. It would use much of the surpluses to enable the OASDI trust fund——

Mr. **Darman**. Not the social security surpluses per se. The key is to get in a situation where, since the rest of the budget would be balanced, that the consolidated budget would in fact be in surplus.

Now, I might just say on your citing Steve Entin, who did work with Treasury, that he did oppose, for what it is worth, the 1983 social security compromise. His position has been consistent all along. He opposes a whole series of things that we are associated with here, but I'm not sure that he should be cited as an authority.

Senator **Kasten**. I want to get this entire quote on the record, and then I want to go back and pick another economist, Alan Reynolds, whom you and I have worked with and have agreed with.

"The administration would retain the 1990 OASDI tax rate and the surpluses. After balancing the rest of the budget by 1994, it would use the surpluses to enable the OASDI trust fund to buy back much of the national debt."

Now, that is the way I view this process. Alan Reynolds called this—and I quote—"a frightening Hoover-esque scheme. Instead of offering to roll back unnecessary tax increases this year, the OMB scheme threatens to add many more unnecessary tax increases in the 1990's for the sake of retirees in the year 2030. This, we think is economic and political suicide."

Now, forget about the Reynolds quote——

Mr. DARMAN. Fine.

Senator KASTEN [continuing]. Or the Entin quote. I don't want you to respond to that. Focus on the economics of what you plan to do. There are basically two ways to pay down the debt. One is to reduce Federal spending, or two is to raise taxes. Those are the two ways that we can get to where we are going.

Mr. DARMAN. To reduce the rate of growth of Federal spending.

Senator KASTEN. From an economic efficiency point of view, isn't it better to finance debt reduction through spending reductions or through reducing the rate of growth of spending——

Mr. DARMAN. Yes.

Senator KASTEN [continuing]. Instead of increasing taxes?

Mr. DARMAN. Yes; I believe it is, provided you are doing so in a way that is itself responsible, but yes.

Senator KASTEN. And isn't it true that higher taxes reduce savings, misallocate resources, and crowd out private sector activity? Those are some of the words we have used in the Republican platform, for example, in 1988.

Mr. DARMAN. Can be and is generally true; isn't absolutely necessarily.

Senator KASTEN. So the real solution is to hold the line on spending——

Mr. DARMAN. Correct.

Senator KASTEN [continuing]. So that as a percentage, the debt as a percentage of GNP begins to decline——

Mr. DARMAN. Correct.

Senator KASTEN [continuing]. And second, we need to do everything we can to encourage private savings, not forced government savings——

Mr. DARMAN. Correct.

Senator KASTEN [continuing]. And the Administration Family Savings Act is a good, I believe, first step, not only a first step, but——

Mr. DARMAN. Alan Reynolds is opposed to it.

Senator KASTEN. Well, I don't know about——

Mr. DARMAN. But he is the same authority you cite for your other argument.

Senator KASTEN. Well, the point is we are in agreement on taxes as opposed to spending, and in my opinion we've got to do more on the saving side.

Mr. DARMAN. Senator Kasten, could I just correct one thing if I might quickly, though. You are right, I have agreed with you and with Alan Reynolds on many things over the years. Alan Reynolds wrote that piece, I may say, after having been faxed in New Jersey, where he resides, a copy of a draft of our savings plan, which was completely inaccurate. I had never seen the draft. The draft was an inaccurate draft. He went into a state of near apoplexy, as you can see from that rhetoric, and said that we are about to become the Hoover administration because we are proposing to save more. And his fear, as you correctly suggest, is that the forced savings level would be so high that we would have to have a substantial tax increase.

But he was operating from the wrong plan, the wrong numbers, and a wrong assumption about the way in which we intended to balance the rest of the budget. Apart from that, he was on the right track.

Senator **Kasten**. Well, my time has expired, but we are going to be working with—and I have been talking to him, also—with Alan Reynolds and others in trying to somehow deal with this problem, because 74 percent of the people in this country pay more in social security taxes today than they do in income taxes. And that is not where we should be increasing taxes.

Mr. **Darman**. But one thing, Senator, I think we have to get clear at the start here is, are we trying really to reduce the revenue base? It is a sort of threshold question. Are we trying to reduce the revenue base? Alan Reynolds will tell you he is trying to reduce the revenue base. And if that is the general conclusion, we've got a totally different way we're going to go than if we're not trying to reduce the revenue base.

We are not trying to increase it through increased taxes. But it is a totally different matter to turn around and say what we'd like to do is yank $55 billion out of that revenue stream that is coming in, and then $80 billion, then $100 billion, and so on.

Chairman **Sasser**. I thought you were increasing the revenue base through increased social security taxes; they have been increasing since 1983.

Mr. **Darman**. That's current law. I mean increase beyond current law. We're not trying to increase it beyond current law.

Chairman **Sasser**. All right. Thank you very much, Senator Kasten.

Senator Robb.

Senator **Robb**. Thank you, Mr. Chairman.

I apologize, I have got the flu.

Let me say initially that I appreciate your coming. I'm not quite as enthusiastic about the budget as Senator Gramm was. I would say in comparing it to the last 5 years, we are not really talking about vintage years in terms of budgeting. If that is the litter, it has been a relatively modest litter, perhaps, but I do commend you for what I think is movement in the right direction, and I share particularly Senator Wirth's concern about describing that next step.

Also let me just say that I think your speech to the Press Club that has been dubbed the "now, now-ism" speech, and your introduction to the budget are both eminently readable and helpful.

I would say that you succeed better on the diagnostic side than you do on the prescriptive side, however, in terms of what we might do to address the particular problems.

I'd like to ask your additional comment on simply one part of your introductory material, and that has to do with your "hidden Pacmen". I commend you for highlighting those. Even recently, and not anticipating that you were going to cover those in the prior hearing, I asked the current Director of the Congressional Budget Office for some summation of that, and it was difficult to come up with all the figures.

You do list on page 11 of your introduction several means—let me just read one sentence. "It is to say, rather, that the amortized annual amount of the protected shortfall may be on the order of one-half to 1 percent of GNP, assuming the problem is managed on an orderly basis."

You then list four or five potential solutions one of which you take off the table; a couple of others are obvious ways to address the problem in the long term. My question has to do with any projection of exposure, unfunded liability, anything of this nature that we can reasonably anticipate over a lengthy period of time that might come from any uncontrollable source. And I fully agree that we ought to look at a number of ways to reduce significantly the amount of exposure or unfunded liability. But to the extent there is some—say it is S and Ls or increases, disasters, whatever the case may be—why not consider some approach to setting aside a reserve—States do a "rainy day" fund—something that acknowledges that you are going to have a certain number of unpredictable events that are going to occur that are legitimately outside of your range of control and setting aside money, rather than being surprised each year if we have a range—and I only mention it because you have quantified it with being from one-half to 1 percent of GNP—why not put that money aside in some form so that we could at least account for that portion of the increased national debt each year, which is fully out of line with what we describe as the deficit?

Mr. **Darman**. Thank you, Senator. Thank you for your introductory comments.

Your question, I think, is excellent, and it is part of what I would hope we could work on in the way that I suggested with Senator Sanford as well—to figure out how to get the way in which we budget in any given year to take better account of these obligations for the future—and some form of reserve is appropriate.

As you know, it is a very complicated matter, however, because you have got to also include for certain kinds of assets, depreciation schedules, and then you have also got to include some expected returns from investment. And it is analytically complicated, and ultimately it could be a political mess if you don't have some very carefully prescribed ground rules agreed to as part of the budgeting system. We are working on that, and we would love to work with you and this committee on that more.

I would note one thing. This is a crude, as you suggest, crude way of trying to at least get a snapshot picture of what that reserve ought to be. We did formally take the step for the first time of reserving Ex-Im loans, and they are formally acknowledged; there is a reserve item built in there. We ought to do a whole lot more of that formally throughout the budget, in my opinion. But conceptually, you are exactly correct. We have got to figure out a way to get—not to abandon the cash budget; we are going to always need that; you have got to know your cash position—but to get beyond it and start using some of the more common sensical techniques that are used everyplace but in the Federal Government.

Senator ROBB. Let me just acknowledge my own experience in the State government arena, that any time you leave a significant reserve which is not otherwise accounted for, when you come through the budget process that is the first thing that is attacked—and I acknowledge that—secondly, that it might postpone the day of reckoning on some of the decisions that you are talking about making. But thirdly—and this is the point that I think goes more to the question that Senator Wirth raised—I think it is necessary for you and the President to put something on the table first, and then if there are differences on this side of the aisle or wherever they may exist, we can then fight over the priorities, but something has got to initiate the dialogue, if you will, and in that regard I would ask you to think about anything that you can take that first step for us, and then let us, if we disagree, propose something as an alternative. But to say that we are simply going to negotiate, without putting something on the table first representing the executive branch, it seems to me is a prescription for simply postponing getting anything meaningful started.

Mr. DARMAN. Thank you, Senator.

Chairman SASSER. Thank you, Senator Robb.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

Being the caboose on this train, there is not a whole lot that needs to be said from this side that has not been. I would say however that having read the newspaper report of your appearance and the reaction on the other side of the Capitol, that you deserve to be congratulated on your sense of humor and your willingness to come before us today and deal seriously with the problems that face us.

Mr. DARMAN. I tried to get John Sununu to come in my place, but he declined.

Senator BOND. Well, that's one idea. That's not the best one I have heard yet. [Laughter.]

But I do find much to support in the statements of Senator Gramm and Senator Kasten, and I appreciated the comments of Senator Robb.

I would be interested in hearing your responses to some of the very thoughtful statements that were raised earlier on by members of this committee, that you possibly may not have had an opportunity to answer fully. I apologize for having to step out on one occasion, but there was a question raised about whether the OMB presents its rosy scenario in January and then comes back and makes a more realistic assessment in midsummer, I guess, at the August snapshot.

Would you care to comment on the revisions you make, the process that you follow?

Mr. DARMAN. Yes; of course, I have only been there for one forecast so far of our own, which is the midsession one, and now this one, which is a continuation of that one. We didn't change it. In other words, this one is a midsession forecast. It is the July midsession forecast. I don't recall at the moment who raised that problem. I don't quite follow it, because when we do revise at the time of the midsession to what some refer to as more realistic estimates, we create a problem not merely for the Congress but for ourselves if it makes the deficit look larger, because it is the midsession estimate that determines sequester, not what we do now. And on the question of whether somehow perhaps the political system is being misled because at the start of the year it accepts OMB's assumptions, on that, I'd have to refer you and your colleagues to the record. I think it will demonstrate that every single year at about this time, everybody has said nobody should follow the OMB assumptions; those are ridiculous; we should throw those out. And then, 2½ months later, the Congress votes for them.

I don't think we can be held accountable for the Congress deciding, for whatever reason it happens to decide, that the same forecast it dismisses at this time of year as irresponsible, it adopts in April.

Senator BOND. I have an opening statement that I have submitted for the record, which makes that point, in case anybody wants to read it. At this juncture, I am not sure that they will, but I agree with you on that point.

[The opening statement of Senator Bond follows:]

OPENING STATEMENT OF SENATOR BOND

Mr. Chairman and Senator Domenici, it is a pleasure once again to have the opportunity to listen to our distinguished friend, and now world renowned commentator on childrens television, Richard Darman.

I must admit that the new Budget book has some interesting turns of phrase. In particular, the Sesame Street section, as well the discussion of various video games qualify as "interesting". . .

But I think you saved your best work for the beat the budget game, and your challenge that: "At some point we have an obligation to be serious". I agree.

So let me spend my remaining minutes discussing several serious topics. First, I would like to compliment the Administration for giving us a budget we can work with. Certainly there will be disagreement—we have heard some here already—in that some will want tax increases; some, more funds for other programs; and some will want bigger defense cuts.

But I believe this budget is basically on-target, both in its recognition of the short-term problems we face; but also in its willingness to touch on potential problems of the future—something that we in Congress often overlook.

I also believe we must commend the President for setting priorities. Like the rest of us he would like to have his cake and eat it too, but unlike many of us, he must put his ideas on paper and suggest cuts in order to pay for increases elsewhere.

Many of his cuts won't be popular, most of us will criticize one or two—but how many of us will suggest alternatives? How many will propose other options? Unfortunately, most will probably stick to criticizing.

And if the Washington Post articles I read this morning are any indication, the opposition is centered around a few basic points:

(1) Resubmitting "shopworn" deficit reduction ideas that "have no chance of passage."

To those I say: How many years did Senator Dodd push childcare, how many years did Nunn and Goldwater push military reorganization; how many people believed John McCain could get catastrophic repealed? If you don't push ideas you believe in—regardless of naysayers, then you shouldn't be in government.

(2) "Smoke and mirrors."

To note that this the pot calling the kettle black is far too tame. Instead we should recognize this comes from the House, where their idea of a deficit reduction bill is that for every penny saved today, let's add a program in the outyears. Now if that isn't smoke and mirrors—then I don't know what the words mean.

Thankfully, last year the Senate finally sickened itself enough that we stripped out all the "goodies" from reconciliation. And did we pat ourselves on the back. Of course the House couldn't quite see our point, and probably doesn't today. But that won't keep their Members from screaming about "smoke and mirrors."

(3) "If the President isn't serious, why should Congress?"

Now we should remember this comes from a Member who is calling for the repeal of G-R-H, the only serious tool around.

(4) "Unrealistic economic assumptions."

On this point, just one observation—who was closer to the actuals last year, CBO or OMB? The clear answer is OMB.

As far as the rest of the complaints, it seems to me they fall into the category of political impotence—some in Congress don't seem to like the voters "interfering" with their policymaking. And when constituents agree about no new taxes, some folks don't like the message. So, take it out on the messenger—our friend Mr. Darman.

I just have one more point to make. The two stories next to the Darman story note that the Democrats don't like the base closings; and that Social Security should continue to be a political football. It seems to me this entire theme is that the time of governing and addressing our problems, rather than running for reelection is over—and I think we all lose because of it.

I'll just close by paraphrasing what Chairman Rostenkowski said last night on McNeil/Lehrer when discussing the Moynihan Social Security plan:

"That's politics, but some of us must be responsible for the actual governing of this country."

I hope this committee follows this lead, rather than the House Budget Committee's.

Senator BOND. There is another question raised by Senator Johnston, about the money for SDI, strategic defense initiative, in light of the changed threat from the U.S.S.R. I would ask your comments on that and note that last night, I saw a very thoughtful comment by Senator Nunn in which he said that as the changes are reflected in our defense policy in response to the changing threats of the Soviet Union, we must be careful not to take steps in the United States that we cannot reverse as quickly as the Soviet Union can should they choose a different policy.

Would you comment on the SDI recommendations in light of the perceived Soviet threat?

Mr. DARMAN. Yes; thank you, Senator.

One, this is an example of a program which was scheduled to increase to—I'm going from memory—something like $5.7 billion, which we are now proposing to increase to $4.7 billion. So relative to the previous plan, it is a cut. Relative to the previous year, it is an increase. But relative to the previous plan, we ourselves are proposing some cut—about a $1 billion cut.

Second, it seems to me that clearly this has got to be part of strategic arms negotiation, or it has got to at least be interrelated with—it doesn't have to be part of the negotiation, but it has got to be interrelated with—what is going on in strategic arms negotiations.

But increasingly I think people are concerned—and I am certainly among them—about not merely the Soviet nuclear ballistic missile threat, but the threat from what we might call third parties. And I think we are eventually going to come to view it as desirable to have some sort of defensive system against third parties who may have a capacity that is highly destructive and where we can't count on traditional rational deterrence.

Finally, I would just say that even if you thought that for all those reasons, you shouldn't be interested in SDI, the R&D elements in SDI and the allocation of R&D resources through that program are probably allocations that society is going to wish to make anyhow.

Senator **Bond**. May I interrupt just to say in response to your point about Third World countries, does this mean that the administration will now support our accidental launch protection system, which we have been hoping to see supported, hoping in vain during the 1989 session? Can we look forward, perhaps——

Mr. **Darman**. You are beyond both my area of expertise and proper domain for comment, and——

Senator **Bond**. But you have just made an excellent argument for it. I hope that others in the administration will heed your words.

Thank you, Mr. Chairman.

Mr. **Darman**. In my worry about third party, I'm a little bit on my own, though.

Senator **Bond**. Well, you are with us.

Chairman **Sasser**. The Director can argue both sides of that argument, I believe.

Senator Hollings?

Senator **Hollings**. Welcome, Mr. Darman.

Mr. **Darman**. Thank you, Senator.

Senator **Hollings**. I appreciate your highlighting the fact that we are complaining about your economic forecast projections now in January, and come May or June, we will adopt them in law. That is a good point to be made, and it takes what Senator Robb says and really brings it into focus. He says we ought to put something on the table.

The fact is we do put something on the table. Both sides say "Read our lips." We claim that we are against the size of government, we are against the gravy train, we are going to stop throwing money at every problem. And the people in the country really believe that so long as you don't raise taxes, you don't increase spending. And we continue to tell them and have them believe that there is a free lunch, when the truth of the matter is we are increasing spending like gangbusters.

The budget in 1980 was right at $590.9 billion. Now you are talking in terms of $1.23 trillion for 1991. So here we go, and President Reagan more than doubled the Federal budget, despite all his rhetoric. I can't get through to the public that we have been spending way more by "reading our lips." We have had 38 Presidents, 200 years of history, and we went through all the wars—Revolutionary, Spanish American, Civil War, World War I, World War II, Korea, and Vietnam—and the entire debt came to $914 billion, with a gross interest cost, as pointed out by Senator Simon, of $74 billion. Then, under one President we tripled the debt and tripled gross interest costs.

By this absolute political profligacy—and that is exactly what it is—we say that there is no problem—that is what the President is going to say tonight, that the country is in the very best of hands, and there is no problem at all—but we have one: Reelection. So "read our lips." We are for all the programs—education, crime, capital games, you name it, drugs—anything you can think of, we are all for it, but read our lips. We say it doesn't cost money; we have just got to cut spending. And we get into this ritual about whether we ought to save more, spend more, and everything else of that kind. The whole time we are spending more, and in essence, now that you've got a gross interest cost, jumping over the past 9 years from $74 billion to $237 billion, and jumping next year to $260 billion, already now we have launched a vast new spending program. Under President Reagan, who was going to eliminate all the programs, cut taxes, stop spending, read our lips—we have started a new spending program of $163 billion—not for nothing, but for reelection. We don't get any government programs out of it.

That is why I use the word "charade". I'm in it, you are in it, we are all in it. And I want to know when it is going to stop and when we're going to sober up, because we actually can save money by raising taxes.

Medicare has gone up to $100 billion. Reelect care has gone to $237 billion in 1990 and jumping to $260 billion in 1991. Imagine that—we start a new year with a new fiscal program worth $23 billion—money that we have got to borrow in order to finance the debt.

All the wish list of programs—drug war, child care, education, you name it—would not cost $23 billion, but we are going to spend that $23 billion anyway in interest on the debt. And you say this is hidden in your budget—but it ought to be on the front page of the budget.

Governors don't run up such deficits. Governors would have to raise taxes. The mayors, who have just been in town, are entirely nonplussed; they can't understand it. They would lose their credit rating up there in the bond market in New York in 10 seconds if they operated the way we do. They couldn't pay the policemen, the firemen, or anybody else.

Now, I tried. When I was the chairman of budget we put in the first reconciliation package to cut spending. Then I put in a freeze; then I put in Gramm-Rudman-Hollings; now, I've got a VAT.

Can't you help me eliminate this program of reelect care? That's what it is. That's why we will all get together later in May to agree on your projections, because it helps us spend more money. Can't we just stop the spending by putting in the revenues and paying the bills like all other public officials are required to do all over this land?

Mr. **Darman**. Well, Senator, what I think empirical analysis has tended to show is that the single biggest determinant of reelection or not in a presidential race—I think it is also true in House races—for an incumbent is the state of the economy. So I would say if one were interested in reelection, purely, what we should be focusing on is what is the set of policies that is going to assure continued and preferably rising economic growth.

And from our part, I could say to you that—obviously, there are many other reasons we should be for it other than just getting reelected—people like me don't run for office as it happens, probably couldn't ever be elected—I guess I see some people wondering when I use "probably"—certainly could never be elected——

Senator **Hollings**. I like Jesse Jackson. I'd like to get you and him to run. That would solve two big problems I've got. Go ahead. [Laughter.]

Mr. **Darman**. Well, I know the outcome in my case.

For my part, I'd be prepared to say if, for whatever reason, we are interested in continued economic growth, and that's what we've got our eye on, now and in the future, then let's sit down and talk about these various measures on the merits as they relate to growth.

And I am not sitting here, sir, and saying to you: No new taxes, read my lips, or anything of the kind. And I would be surprised if the President used the "read my lips" formulation tonight, although I can't promise in his behalf, but in any case——

Senator **Hollings**. It is really embarrassing to see a President of the United States standing up, saying, "Read my lips." It is demeaning. It is telling the country we don't need taxes. That's my whole point. And that is what you are saying, and that is what we are saying. And yet we go merrily along, raising the spending, spending, spending, way, way, and above for nothing, for interest cost.

Mr. **Darman**. But Senator, may I respectfully—and I genuinely mean "respectfully"; I've got enormous respect for you personally, and I would——

Senator **Hollings**. That is mutual. I have for you.

Mr. **Darman**. Thank you.

Senator **Hollings**. I wish I was as smart. Go ahead. I don't see how you do this job.

Mr. **Darman**. I think you are smarter. But in addition, you probably have quite a lot—I'm sure people would say, and I might even agree—you have got more courage than I do. No one can criticize you the way several here have criticized me for not being willing to be bold. You put your ideas out on the table. You may recall earlier when I said I expect that Senator Hollings will violate the pattern, and we will at least have from Senator Hollings some specific proposals. And you have done that——

Senator **Hollings**. And win the Al Ullman award. He is out there, still explaining it. Go ahead.

Mr. **Darman**. But however, I will say this, if you will pardon my suggestion. You used to be for the value-added tax as you are now for a whole bunch of reasons——

Senator **Hollings**. No, for one reason—I said put it over in Treasury where you were, for the deficit and the debt. Now, we have testified for 3 years, and that's where we had Charles Walker, Dr. Criossen and so on before the Finance Committee last year. Now that we've got the Moynihan idea, I said you can't pile another $55 billion on the deficit; let's use the VAT to compensate, and stop what they call thievery.

Mr. **Darman**. I understand, and what I was just going to suggest is that I don't see how you can take your line of reasoning, which I understand every step of the way, I believe—I might differ on some of the measures, as you know, but I agree with the line of reasoning—I don't understand how one can at the same time seriously entertain proposals that would yank $55 billion out of the revenue stream. You at least replace it. Very few of your colleagues have been as direct as you in talking about how they would replace it. And although I don't agree with your form of replacement, I at least congratulate you for recognizing that we ought not in this context to be yanking $55 billion out and saying, "Forget it; it doesn't count."

But I really have trouble understanding the merit of that piece of the proposal. Why do we need $55 billion less from that at this stage and $80 billion the next year and $120 billion the next?

Senator HOLLINGS. Well, that is right to the point of what Senator Moynihan has said. This particular month—and this is January—we have increased social security taxes not for the trust fund, not for a reserve. We are not reserving the reserve; we are spending that money to bring down the deficit.

Mr. DARMAN. But we can fix that.

Senator HOLLINGS. The simplest way to cut out the thievery is let's just don't raise the social security taxes.

Now you come in with this budget—and if I had time, I'd go into it—and you raise taxes another $2.1 billion on State and local employees. You are raising social security costs another couple billion—for what? Aha, it's not going in the trust fund; it is going in the slush fund that you folks are keeping over there. That is the big problem we have, that's what doesn't make sense. We have got to put a stop to this pell-mell, down the road, read our lips, reelect us approach to fiscal policy. It is the most irresponsible government I have ever seen, and we are all to blame, both sides, the Congress and the President.

Mr. DARMAN. Well, there is no doubt that Senator Moynihan's proposal has gotten an awful lot of attention, but I would like to at least note this. The problem had your attention long before his proposal. It so happens it also had my attention; indeed, I proposed our debt buydown fund publicly in October, and his proposal did not come until December 29. So there were at least some of us who recognized the need to straighten out the way you handle social security and its relationship with Gramm-Rudman and in relationship to the objective of balancing the social security portion of the deficit. That, I would call one problem. And that one, we ought to solve.

Senator HOLLINGS. Go ahead. I'm sorry.

Mr. DARMAN. There is a separate problem, which is the problem created by his proposal, which doesn't really try to solve the problem; it creates a whole new flock of problems.

Chairman SASSER. Mr. Director, we are reaching the end of the line here, and I'm sure Senator Symms has got some additional questions. But before we turn to Senator Symms, I've got one or two questions and observations I'd like to make.

You have presented to this Congress on behalf of the administration a budget that calls for $1,200,330,000,000 worth of spending. It is such a mind-boggling figure, it is hard to conceptualize it, and then verbalize it.

Now, of that budget that you have presented, we are essentially going to do combat over about $12 billion of it when you blow all the fluff away; that's about what it amounts to. Now, if we look and see what has occurred over the past decade, and as we look forward into the next decade, we really find that we are not making any progress against our gross indebtedness. The national debt went up by $265 billion between 1989 and 1990. The accepted figure is that we had a $150 billion deficit.

In fiscal year 1990, CBO is saying we are going to have a $138 billion deficit, and I suspect OMB agrees with that, or close to it, now. Actually, it is going up to $272 billion in gross debt, and that does not include the off-budget S&L liabilities there.

In 1991, you are saying we are going to have a deficit of $100 billion; CBO says $138 billion. But you and I both know there is going to be a gross indebtedness—or I know it, believe it to be true—of $278 billion.

And we see that what is happening is that our gross indebtedness as a percent of gross national product is not shrinking. It is up very dramatically over where it was in the decade of the seventies. In 1989, it is 58 percent of GNP, the relationship between gross indebtedness and GNP. In 1990, it did fall down to 57 percent, we predict. In 1991, it will be back up to 58 percent. In 1992, the projections are 58 percent. And if we continue current policy, it starts climbing above 58 percent again in 1993.

Now, given that scenario, why do we continue to sort of nibble around the edges here? You indicated yourself a moment ago in response to a question from Senator Wirth or someone that we could either take these steps to remedy this fiscal problem with small steps, with larger steps, or we could sidestep it.

I would submit that we are continuing to sidestep it, and I once again pose to you the question: How do we go about taking this larger step? Give us the recipe for that here today.

Mr. DARMAN. Mr. Chairman, thank you.

I am glad you pointed to indebtedness as a percent of GNP, because if you look at that measure, which is also a very important measure, you could say that although the nominal amount of the debt is rising, that is stabilizing; so instead of just pointing out, as you do, that it is a big number, you could say, well, but it isn't going up all that much, so let's not worry about it. We are not taking that position.

And the reason I want to make clear that at least I am not taking that position is not because I don't think you can sustain 50 some-odd percent; it is because I see coming in the future some borrowing needs, and I'd like to get us in a position where we dip down before we have to come back up, because above some level, it is an intolerable burden or an imprudent burden.

Chairman SASSER. We have a banana republic.

Mr. DARMAN. At some point. Now, of course, in our history, we have gone all the way from zero to 110, and we are about in the middle of the range. But I'm saying because we've got these big problems coming, we've got to get it down before it goes back up. That's why we should get it down; it is with an eye to that future problem.

On the issue you raised about how do you take a larger step, two comments. One, we made a responsible step. You differ. It would be nice if this were at least treated as if it had something to offer, even if people say it is not enough. That would be a useful start.

The next parts of the steps, I believe—and you know I believe; we have talked about it many times—you have got to discuss privately, because the way the political system has tended to work is that as soon as somebody puts forward any idea that looks difficult, other people take advantage of them politically. I'm not saying the

Congress takes advantage of the Executive; it has been both ways. So every time I say that, I frustrate people——

Chairman SASSER. And we talked about that last year.

Mr. DARMAN. And you and I know that we didn't succeed. So neither of us is too optimistic at the moment about what is going to happen this year. For my part, I'd like to continue to try. I have read in the newspaper where you and Senator Mitchell don't want to try. If you don't want to try, I'm not about to say, "Well, OK, you win; we'll throw this out, and we'll be back in a little while with a new one."

Chairman SASSER. Well, I can't speak for Senator Mitchell, but I know what my attitude has been, and I think it has been reflected accurately in the press, and that is I am discouraged. We are not slamming the door, but we are discouraged. And I get the impression that the administration now feels as if it has got the upper hand.

Mr. DARMAN. No, sir.

Chairman SASSER. This President is riding on a bubble of popularity in the polls. You have the sense that perhaps the recession is not right around the corner, which seemed to be the sense at the beginning of last year. So let's slip by for another year or two and just see how far we can go.

Now let me just give you one word of warning for whatever it is worth, and you can choose to accept this or reject it as you wish. But you indicated yesterday before the House Budget Committee that the Moynihan proposal had quieted down. I want to tell you that that Moynihan proposal is still very, very operative, and that shotgun behind the door called "the Moynihan proposal" is poised very precariously, and the first little rumble could knock it to the floor, and it could go off accidentally. And when that occurs, you are going to lose this $66 billion worth of revenue that is projected coming out of the social security system in 1991, and it is going to be lost permanently from there on out..

And I don't say that in a threatening way. I just tell you what I pick up around here in the cloakrooms and the hallways and the byways. And let me tell you, the waitresses in Knoxville, TN are talking about getting their social security tax cut. And when it gets down that deeply, it is having an impact on the country.

Senator SYMMS. Mr. Chairman and Mr. Director, I will try to be very brief because you have been very patient and an excellent witness.

Mr. Chairman, I have to make the observation in relation to the earlier colloquy between Mr. Darman and my good friend, the Senator from South Carolina, about Mr. Darman running for office. I just want to say that if brains and courage were a requirement for getting elected to office, you would be a landslide winner.

Mr. DARMAN. Thank you, Senator.

Senator SYMMS. I want to get that on the record first.

Chairman SASSER. I'll warn you, that's not the only requirement, though.

Senator SYMMS. That's not the only requirement? The fact is, that is not a requirement at all. [Laughter.]

But I do want to say with respect to the Moynihan proposal—and I say this for the benefit of the chairman—that if Senator Moynihan chooses to offer his proposal on the floor or have it presented in this committee—since he is not on this committee.

Mr. **Darman**. He is on Finance.

Senator **Symms**. But if that comes up, it is my intention to offer an amendment to it to allow the President's family saving account plan to go with it.

Now, I view this problem as an apple grower. We start planting trees today that we want to harvest 20 years from now, or maybe 30 years from now, or 40 years from now. If we could take this social security surplus of more than $55 billion and have each American open up their own family savings plan, in a matter of a few years, we would develop an enormous private savings pool. It would be a good compromise between the outright Moynihan plan and your plan—and I would rather have it than nothing, I'll say that; I think your plan has got some merit to it—but then the question will be, what do you do about the $55 billion? Well, there is one way we could do it, and that would be to admit that we cannot balance the budget in 1993 and then slip the date to 1995 to hit the target date. Now people say, "Well, you are hiding the deficit, you are masking the deficit." Anybody who has ever talked to financial managers, watched them trade bonds, or who has any idea about what goes on in the financial markets, knows we are not hiding anything in Washington; everybody knows down to the last dollar how much money the government has to borrow. That is the ultimate test of what is happening, namely how the markets react.

So I think that there is a possible compromise here. I think 20 years from now, if we took my plan and started putting the surplus into individual accounts, that there would be a huge private savings pool, and as I said, the only downside would be that we'd have a harder problem solving the budget deficit right now. But there is a solution to that also. If we slip the targets a few years and reform Gramm-Rudman-Hollings not in the way that has been suggested by Senator Kasten we would have a balanced budget soon enough. And we could even make sequester more inclusive, and put everything in the sequester, put the Congress on "autopilot" if we can't reach a budget agreement, and let the sequester fall in place. It could be very minimal across the board on all functions of the government; it would be very minimal, and I think we'd find we could live with it, and we would solve our problem. We would develop a private savings plan, and that wouldn't be the worst of all worlds.

So I would just ask you as Director of OMB, rather than panic too much over the budget numbers if the Congress passes the Moynihan proposal, look at it philosophically, that it will reduce the income stream to government, it will reduce the number of regulators that the government will be able to hire who go out and interfere with the business of producing a better world for us to live in, and there could be a plus side to it.

So my view is that if we starve the government some, put it on a diet—the deficit is bad, and I don't like it. But at least it holds back the profligate spenders in Congress, so that they can't come up with new schemes, because they still have to face this deficit problem. There is a silver lining in this cloud, and I would hope that you would look favorably, if this comes to pass. I know all the small businessmen in my State are calling me, the NFIB; they want the Moynihan proposal—and I personally, as one Republican, am not opposed to the Moynihan proposal, but my view of how to increase our savings rate may be somewhat different. I do not agree with my Republican friends in the House who think that somehow they are going to earn votes by opposing a tax cut. I don't buy that. I think in the long term the best thing for the country, would be a large private savings pool owned by Americans, and a government on a diet, with a long-range plan to balance the budget. It is in the best interest of all Americans, both Democrats and Republicans, and that it is doable. And I am not pessimistic.

I think this budget is doable. I think what we need to do is not to enact something here in Congress that will create a recession, whether it be excessive regulations or excessive new spending programs or anything to disrupt the tax system. That is why I don't support Senator Hollings. I think this is doable, and I hope that you and the chairman and Senator Domenici and others in the administration and the Congress can get together, resolve this budget, and that we can get on with it because the markets will respond very favorably to this if we could do our job down here.

Now, I'm not opposed to just a straight-out sequester. I don't like the sequester the way it is because it is not inclusive enough. It has too many sacred cows. But it is not all that bad. We could just go on and sequester for 12 more months. I think the world would respond very well to it, and it wouldn't be that bad.

Chairman SASSER. Well, thank you very much, Senator Symms.

Senator SYMMS. Thank you for being here.

Chairman SASSER. Mr. Director, we appreciate very much your appearance here this morning. We have been impressed by a lot of things, not the least of which your ability to consume a pitcher of water and still be cheerful for 3 hours and 15 minutes.

On that note, these hearings are in recess.

Mr. DARMAN. Thank you, Mr. Chairman.

[Whereupon, at 1:15 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR SASSER TO MR. DARMAN AND THE RESPONSES

Question. Mr. Darman, the press has reported that you have compiled a list of 73 high risk programs in 16 Federal Agencies. This list was the results of responses to a request you made to agencies last June to review their internal management controls over Federal programs.

1. Please provide the Committee with this list.

2. Please provide the Committee with any additional background material that would indicate the extent of these problems and estimate potential cost to the Federal government.

Answer. 1. Attached is the complete list of 106 high risk areas for the Cabinet agencies and the independent agencies. This list was furnished previously to the Senate Governmental Affairs Committee and the House, Government Operations Committee. We are reviewing the Agencies' 1989, year-end internal control reports required by the Federal Managers Financial Integrity Act (FMFIA), and will update the high risk list as necessary, once the review is completed.

2. Each agency is required by the FMFIA to report annually to the President and Congress on the status and condition of its internal management controls. The 1989 reports were furnished to the President and Congress on December 31, 1989. These reports include background [1] and detail on the high risk areas, in particular, the

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[1] Background material on file with Budget Committee.

plans agencies have made to prevent or correct them. Attached are copies of the 1989 FMFIA reports which provide background to the high risk areas.

The Deputy and Executive Associate Directors of the Office of Management and Budget are meeting currently with the Assistant Secretaries for Management of each of the major agencies to discuss the status of the agencies internal management controls as well as other priority management issues. They will hold additional meetings with the Deputies of selected agencies to discuss progress in correcting outstanding management control problems, and other management issues. OMB intends to institutionalize a management oversight process through such meetings in the Spring of each year to complement its Budget review process in the Fall.

OMB does not have presently a good estimate of the cost to the Federal government for completing corrective actions to all the high risk areas on the list. However, steps are being taken to better link the management control process to the budget process. We are reviewing the data provided by the agencies, and we will request cost data for those instances where the improvement of internal management controls has budgetary consequences. We should point out that preventing serious weaknesses before they become unmanageable or correcting identified problems does not always require additional resources but rather may require other management action or organizational adjustment.

HIGHEST RISK AREAS

DEPARTMENT OF AGRICULTURE

1. FOOD AND NUTRITION SERVICE: Longstanding inability to trace Food Stamp Coupon redemption to individual vendors and to reconcile these payments with authorized redemption. $11 billion in coupons are redeemed annually by 230,000 approved retailers. At the end of FY 1988 the coupon liability account was $609 million.

2. FARMERS HOME ADMINISTRATION: FmHA administers direct loan programs totaling $58.1 billion and guarantee loan programs totaling $5.3 billion to farmers and businesses. Twenty nine percent of the direct loans are delinquent. Following are problems associated with these programs.

    (a) FmHA accounting systems need better security and program information systems should be upgraded.

    (b) Debt write-offs and buy-outs at "net recovery value" under the 1987 Agricultural Credit Act need scrutiny for possible fraud and "bad faith" delinquencies. Subsequent recapture of capital gains by borrowers who sell their property after net recovery buy-outs also need scrutiny. Quality control in these areas has been found inadequate in certain states.

    (c) Recovery of guarantee claim costs from defaulting borrowers (farm programs) with remaining assets is not adequately pursued.

    (d) There are insufficient site visits or financial audits to protect pledged assets backing FmHA direct and guaranteed loans, especially in the farm and Business and Industry (B&I) programs.

    (e) There is inadequate management and tracking of the disposal of properties acquired by the Government as a result of defaults, especially in the farm ownership and single-family housing programs.

    (f) The system for awarding Section 515 multi-family housing loans may be insufficient to assure unbiased application of published selection criteria. Improved oversight and controls may be warranted.

3. FEDERAL CROP INSURANCE CORPORATION: Private insurance firms sell and/or service 85 percent of all Federal multiple-peril crop insurance. The integrity of claims adjustment and timely remittance of premiums to FCIC by these firms is an ongoing concern. This is particularly true where reinsurance agreements do not transfer significant risk to the private

insurers, reducing their incentive for protecting the Government's interests. A recent audit by a CPA firm was unable to provide an opinion on the adequacy of FCIC internal controls in reducing the risk in these areas.

DEPARTMENT OF COMMERCE

4. **PATENT AND TRADEMARK OFFICE (PTO):** There is a lack of adequate controls over file integrity and security in PTO. Seven percent of the 27 million patent search file documents are missing or misfiled. There are 358,000 pending applications. Numerous improvement actions are underway, including the Automated Patent System. While improvements have been made, additional steps need to be taken. These actions were disclosed by the second Industry Review Panel convened in August, 1989.

5. **MAJOR SYSTEMS ACQUISITIONS:** There is a range of systems, procurement, and management issues that adversely affect the ability of Commerce and its bureaus to acquire major systems. The Department has experienced delays and cost overruns in major systems that can have a significant impact on program delivery. These include systems related to patent processing, weather programs, and financial information. Increased attention to systems management and acquisition is needed to achieve adequate controls over major systems implementation.

6. **ADP SECURITY:** There are longstanding material weaknesses in the security of ADP sites Department-wide. There have been significant efforts to correct this problem, but correction dates have been slipping and top management priority should be given to meeting the planned September 30, 1990 correction date.

7. **FINANCIAL SYSTEMS:** The quality of the data in financial management reports is weak. There are particular weaknesses and non-conformances in the accounting systems of the International Trade Administration and the National Technical Information Service. Commerce is undertaking a broad financial management systems upgrade and an overhaul of data architecture, but is behind schedule in their planned improvements because of difficulties in installing software for their core system.

DEPARTMENT OF DEFENSE

8. **SUPPLY OPERATIONS:** Each year the Department of Defense manages 4.9 million supply items and maintains a supply inventory valued at $103 billion. DoD has identified 18 material weaknesses in supply operations. These include: inadequate assurance that items are received before payments are made; ineffective management of spare part inventories; and inaccurate catalog identification numbers. These weaknesses lead to payments for goods not received and no assurance that materials listed as available in inventory are physically warehoused and available for use. DoD has classified supply operations as a DoD-wide internal control issue.

9. **SECURITY ASSISTANCE:** Over 16,000 Foreign Military Sales (FMS) cases (with an estimated value of $142 billion) were unresolved as of September 1987; $54 billion of these consisted of undelivered orders. DoD has identified 4 material weaknesses in this area. FMS problems are longstanding and are primarily related to financial systems and unreconciled balances between disbursements from the FMS Trust Fund and deliveries made to FMS customers. This prevents assurance that FMS customers are charged all applicable costs and surcharges.

10. **CONTRACT ADMINISTRATION:** DoD initiates each year about 15 million contract actions valued at about $160 billion. DoD has identified six material weaknesses in this area. These include weaknesses in the utilization and management of government property in the possession of Defense contractors and post award contract administration functions. There are significant risks that contractors (who currently hold $56.5 billion in government property under contract terms) could acquire material not authorized under their contracts as well as other problems.

11. **INFORMATION TECHNOLOGY/ADP SECURITY:** Defense will spend roughly $9 billion on ADP in the coming year. DoD has identified 10 material weaknesses in this area. Inadequate ADP equipment and property accountability records, lack of an implementation plan for the programming language Ada, and insufficient security for automated systems are all specific weaknesses. More than 50,000 computer security plans are still undergoing independent review.

12. **CONTRACTED ADVISORY AND ASSISTANCE SERVICES (CAAS):** The Department reports it will spend $1.6 billion on CAAS in FY 1990. However, the DoD Inspector General has indicated that the Department's management and oversight of this area has

been a long-standing problem, which has received considerable attention from the Congress as well.

DEPARTMENT OF EDUCATION

13. **STUDENT FINANCIAL ASSISTANCE PROGRAMS:** Some institutions participating in the grant and loan programs have abused the assistance programs by enrolling unqualified students, or by their failure to provide adequate training. This leaves students with high debt burdens and no skills. There is also lax administration by some private lenders and state guaranty agencies. Over 1.8 million students are seriously delinquent in loan repayments, with delinquencies in aggregate of $4.5 billion. There is a need to consider new strategies, including:

    (1) Separate requirement (legislation and regulation) for proprietary schools.

    (2) Stricter controls over the accreditation/eligibility/certification process.

    (3) Elimination of the abuses of the "ability-to-benefit" provision for admitting students who do not have a high school diploma or GED.

    (4) An enhanced role for guarantee agencies and private lenders in curbing abuses.

    (5) Development of adequate data about students, postsecondary institutions, lenders and guarantee agencies.

14. **PROGRAM MONITORING AND ACCOUNTABILITY:** The Department provides billions in financial assistance for education throughout the country. However, little is done in the way of monitoring the formula and discretionary grants to ensure that recipients are complying with grant terms and conditions, properly accounting for these Federal funds and focusing on educational achievement for target groups. Stronger monitoring plans need to be established and implemented. In addition, suspension and debarment procedures need to be performed in a timely and effective manner to protect the Federal interest.

15. **CONTRACT AND GRANT AWARDS AND CLOSEOUTS:** The Department awards about $1 billion in discretionary grants each year. In the rush to meet deadlines, unnecessary, excessive or poorly defined grants may be awarded. Also, expired grants and contracts are vulnerable to unauthorized draws. There is

a need to implement procedures to assure that awards are cost effective and appropriate, that useful final products and reports are received, and to close out expired awards so as to prevent the possibility of unauthorized draws by grant recipients.

16. **FINANCIAL MANAGEMENT:** Recent reviews by internal management have uncovered a number of weaknesses that effect the Department's ability to generate reliable accounting data. In particular, there is need to improve controls over the Department's program systems, that feed data to the central accounting system. Plans to extend internal reviews to all feeder systems should be implemented expeditiously.

17. **ADP SECURITY:** Education uses an extensive ADP network (i) to award and disburse over $18 billion in financial assistance annually and (ii) monitor the collection status of over $68 billion in direct and guaranteed loans. Scheduling and performance of security reviews need to be accelerated to assess the overall adequacy of ADP security.

18. **MATERIALS WEAKNESS IDENTIFICATION AND AUDIT FOLLOW-UP:** The internal control review process needs redesign to assure that material weaknesses are properly identified. The current approach has resulted in a failure to identify material weaknesses or in inappropriate identification of them as minor. Also, procedures need to be put in place to assure that corrective actions have actually been taken to address deficiencies noted in audits and other reports. This includes validation of such actions.

19. **REVIEW OF THE OFFICE OF SPECIAL EDUCATION AND REHABILITATIVE SERVICES:** This office has come under scrutiny by internal management and subsequently the General Accounting Office due to allegations of mismanagement as well as questions concerning contract awards. Specific plans should be formulated to identify and remedy problems in the management of this office. Experiences gained from this project should be applied to reviews of other offices.

DEPARTMENT OF ENERGY

20. **MAJOR SYSTEMS ACQUISITION AND PROCUREMENT:** The Department of Energy obligated about $15 billion in 1988 for procurement. There are inadequacies in the major systems acquisition as evidenced regarding the vitrification plant in Hanford and the Waste Isolation Pilot Plant in New Mexico. There are also weaknesses in the $11.5 billion procurement program for government owned, contractor operated (GOCO) facilities. Top management effort is required to develop a list of specific

weaknesses to be corrected, an action plan, and an overall correction date.

21. **ENVIRONMENTAL COMPLIANCE:** There are significant environmental problems at the Department's nuclear plants. These include inadequate controls of hazardous waste and substance releases from active and inactive waste sites. An on-site survey has been completed and prioritization of actions has begun. There is also a need to establish financial and management information systems to track process of clean-up activities. The DOE estimate for clean-up costs in the FMFIA report was $90 billion.

22. **HEALTH AND SAFETY:** There are health and safety deficiencies at nuclear facilities with respect to both workers and the public. Technical safety appraisals are being conducted now and an independent advisory committee has been established. The DOE estimate for corrective action on identified deficiencies in the FMFIA report was $5 billion.

23. **DETERIORATION OF DEFENSE NUCLEAR PRODUCTION CAPABILITIES:** Due to decades of deferred maintenance, the complex requires increased maintenance, upgrades, and replacements to meet production needs. All three nuclear material production reactors are shut down for upgrades, leaving no production capability. A plan with cost estimates and schedules is needed for modernization of the production complex as well as for the nuclear material production reactors.

24. **REIMBURSABLE PROGRAMS:** There is inadequate management attention to reimbursable programs, including obtaining full cost recoveries and ensuring that such work does not exceed available funding. There has been no estimate of the potential for additional cost recovery. DOE should review all such programs together with its policies and procedures, and take the additional actions necessary to assure that all reimbursable programs are properly controlled and reported, and that the full cost of such programs is recovered.

ENVIRONMENTAL PROTECTION AGENCY

25. **SUPERFUND PROGRAM:** A recent review of this $8.5 billion program indicated that EPA has to set fair and realistic goals and put controls in place to assure the program's integrity. Fifty recommendations for improvement were made. The agency believes full implementation of the recommendations will help to restore public confidence in the program.

26. **FINANCIAL SYSTEMS:** EPA's financial systems are often inaccurate and unreliable. The Office of the Inspector General has reported inaccurate balances in 40 percent of the agency's accounts receivable (net error rate of less than one percent). Superfund Trust Fund audits have reported that many accounts receivable in the Superfund program are not recorded until after receipt of checks. A recent IG review identified $8 million of such accounts in one regional office.

27. **ENFORCEMENT:** Audits of EPA's asbestos, water, air and RCRA programs have shown that improved systems are needed to help in the identification of violators of environmental laws and regulations. EPA systems also, do not always track corrective actions required of violators until full compliance is obtained. Additionally, Office of Inspector General reports have shown that controls need to be in place to ensure that penalties imposed against violators are calculated in accordance with EPA policy and that adequate justifications are documented to explain the basis for any reductions.

DEPARTMENT OF HEALTH AND HUMAN SERVICES

28. **ACCOUNTING FOR THE CATASTROPHIC BENEFITS PROGRAM:** During fiscal year 1990 an estimated $3.9 billion was expended for Medicare catastrophic benefits. The legislation that underlies the program provides that benefits are to be financed entirely by enrolles. However, the Health Care Financing Administration (HCFA) does not have an adequate accounting system or a sampling system to track actual payments related to catastrophic coverage. HCFA must take immediate action to develop an accounting system designed to record actual monthly program costs on a timely basis, for each benefit and major administrative function of the non-catastrophic and the catastrophic portions of Medicare. Both financial and programmatic data should be collected and available timely to insure adequate and appropriate financing of Medicare benefits.

29. **MANAGEMENT OF THE INDIAN HEALTH SERVICE:** The Department's Inspector General reported that no programmatic FMFIA internal control reviews have been completed by the Indian Health Service (IHS). He also reported that IHS needs to improve documentation to demonstrate effective correction of administrative weaknesses. A number of recent reviews by the Inspector General disclosed broad management weaknesses in the IHS accounting and administrative management systems. The Department and IHS needs to conduct intensive administrative reviews to define needed corrections and that FMFIA reviews are properly conducted for all IHS programs.

30. **OVERSIGHT OF GENERIC DRUG APPROVAL:** There are inadequate Food and Drug Administration (FDA) controls over the approval process for generic drugs. A recent audit by the Department's Office of the Inspector General disclosed that FDA management had not issued internal guidelines to insure consistent review of applications and did not maintain an adequate quality control system. Guidelines must be issued. We are now aware that HHS has initiated intensive review and oversight of the generic drug approval process. If legislative changes are necessary, we would expect HHS to advance such proposals expeditiously. Also, FDA should ensure that its application processes are subjected to FMFIA internal control reviews.

31. **RECONCILIATION OF SOCIAL SECURITY AND INTERNAL REVENUE SERVICE RECORDS:** The Internal Revenue Service (IRS) and the Social Security Administration (SSA) have not completed a reconciliation of differences in employer reported earnings of employees. From 1978 through 1984, SSA recorded about $58.5 billion less in employee's earnings than IRS. A memorandum of understanding between the SSA and IRS requires that SSA reconcile wage and tax records to IRS records up through 1987. We understand that reconciliations have been completed through 1983. SSA should continue the remaining reconciliation, expeditiously, to assure proper credit to all wage earner accounts and prevent inadvertent reduction of SSA benefits to individuals. SSA in cooperation with IRS should develop mechanisms to determine the extent to which differences represent underrecorded wages, to support the eventual credit to the trust fund.

32. **IMPROVED MECHANISM FOR SECONDARY PAYER IN MEDICARE AND MEDICAID PROGRAM:** The Department's Inspector General reported satisfactory progress in controlling payments by fiscal intermediaries; however, improvements are needed in the Medicare Secondary Payer program. A recent review showed that the absence of prompt and exact information has resulted in Medicare and Medicaid payments that are actually the responsibility of other primary payers. A mechanism must be developed, expeditiously, to gather the necessary information to determine responsibility for these payments.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

33. **SECTION 8 MODERATE REHABILITATION PROGRAM:** Serious weaknesses in the administration of this $300 million program at the Headquarters, field and local Public Housing Authority level. These include (i) payments of millions of dollars in excess contract rents due to inadequate controls over developers, consultants and mortgage lenders, and (ii) non-competitive

awards of Sec. 8 moderate rehabilitation subsidies to owners of rental properties.

34. **SINGLE FAMILY MORTGAGE INSURANCE:** In Fiscal Year 1988, HUD wrote over $44 billion of Single Family Mortgage Insurance on over 700,000 units. The Insurance Funds which provided this insurance suffered about a $2 billion loss in Fiscal Year 1988. Mortgagees (lenders) do not properly process applications from individuals who are obtaining loans to purchase homes. Essentially they do not properly verify information provided by the loan applicant and many times the parties involved in the transactions are actively involved in trying to defraud the Government. While the Department is unable to estimate how much of the billions of dollars lost on foreclosures is due to fraud, it is believed that a disproportionate share of the $2 billion loss in Fiscal Year 1988 was attributable to program fraud and abuse.

35. **FHA SINGLE-FAMILY PROPERTY DISPOSITION PROGRAM:** In Fiscal Year 1988, HUD sold over $3 billion in acquired properties. Inadequate controls over sales of these properties provide closing agents with the opportunity to manipulate or take funds for their own use. Inadequate oversight over private area management brokers (AMBs) has contributed to a sharp rise in the mismanagement of foreclosed properties and increased losses at FHA. In addition, significant program planning and monitoring problems have been disclosed by a recent review.

36. **FHA MULTIFAMILY COINSURANCE LOAN GUARANTEE PROGRAMS - SECTION 223(F):** Under this program, HUD has insured 1,223 mortgages valued at $ 7.1 billion. HUD is experiencing excessive losses on multifamily properties. As of September 1989, $800 million (12 percent) was in default and 30 claims for $111 million had been submitted for payment. The Department estimates total claims may eventually reach $406 million. The system is allowing lenders to underwrite unsound loans, fail to detect troubled loans quickly, and take inadequate action to minimize defaults or losses.

37. **CORE ACCOUNTING SYSTEM AND COMPUTER SECURITY:** HUD has reported a material non-conformance in their Core accounting system. This includes very serious problems of data integrity, as evidenced by recent disclosures, in their subsidiary program systems. Also, HUD's security controls are lax and were recently exploited by an experienced employee in the Denver region who diverted $1 million to fictitious vendor accounts.

38. **FHA DISTRIBUTIVE SHARES/ONE-TIME MORTGAGE INSURANCE PREMIUM (OTMIP) REFUND SYSTEM:** In Calendar Year 1988, HUD paid out over $266 million in distributive shares and OTMIP refunds. There are serious weaknesses in the refund payment system, the cash management system and in the procedures for validating

authenticity of claims. There is also a lack of payment support documentation, non-separation of duties among employees, and poor system access controls, leading to overpayments and recurrent payments.

39. **RETIREMENT SERVICE CENTERS:** The relevant rules and procedures are inadequate to ensure that project sponsors have adequate prior experience with RSC's.

40. **DISCRETIONARY LOAN MANAGEMENT/SET-ASIDE PROGRAM:** Awards for this annual $5 million Section 8 program have been arbitrary and poorly documented. Project files suggest that regulatory requirements were not met and that subsidies were provided to developers who did not qualify for them.

41. **DATA SYSTEMS:** There is a serious lack of capacity to produce basic tenant data describing the population served by housing subsidy programs or to monitor compliance by local housing authorities with rules governing selection and admission. There is also a problem in accurately predicting the number of expiring housing assistance contracts that will require renewal in a given budget year.

DEPARTMENT OF INTERIOR

42. **BUREAU OF LAND MANAGEMENT(BLM)/MINERAL MANAGEMENT SERVICE(MMS):** MMS oversees offshore mineral leasing, environmental studies, regulation of industry operations, and collection of onshore and offshore royalties (approximately $4 billion annually). BLM has only 120 inspectors for approximately 24,000 producing onshore oil and gas leases. This is considered by many to be inadequate to monitor the approximately $0.5 billion a year in royalties received by Interior through onshore mineral leases. There is also a question concerning the completeness of the central tracking system of the decentralized BLM state offices.

43. **BUREAU OF INDIAN AFFAIRS:** The Bureau has 21 of the Department's 29 outstanding material weaknesses, many of them long standing and uncorrected. Dates for correcting these weaknesses are continually extended. Controls in such areas as contracting, the $1.7 billion Indian Trust Fund, dam safety, the direct and guaranteed loan program, irrigation and power, and social services are inadequate.

44. **TERRITORIAL AFFAIRS:** Sufficiently trained territorial personnel are not available to adequately oversee, monitor, maintain, and operate financial management systems and the expenditure of Federal funds.

DEPARTMENT OF JUSTICE

45. **BUREAU OF PRISONS:** The 60% overcrowding in the Federal Prison System creates potentially unsafe and insecure conditions for community, staff, and inmates. FPS has a design capacity for 31,000 inmates, but currently houses 50,000. The prison construction plan through 1995 responds to this problem and future prison population increases. Funding and population estimates are being reviewed in the 1991 budget process.

46. **BUREAU OF PRISONS:** Not all prison facilities comply with nationally recognized fire protection codes or regulations on disposal of hazardous waste. Surveys to determine the dimensions of the problem are to be completed in 1989.

47. **BUREAU OF PRISONS:** There are inadequate staff to operate and manage existing and new prison facilities. The ability to recruit, develop, and retain sufficient staff is constrained by inadequate pay scales, poor career development potential, and poor planning and recruiting.

48. **DEBT COLLECTION:** The Tax Division has not fully implemented its new debt collection procedures. The Civil Division has yet to complete automation of its daily reconciliation process. The Executive Office for U. S. Attorneys has yet to complete automation of its case management system. Weaknesses in the debt collection system materially impact the ability of the Department to assure collection of the $7.6 billion in debt that has been referred to it by other federal agencies. No correction date has been established.

49. **IMMIGRATION AND NATURALIZATION SERVICE:** The February audit of INS found significant weaknesses: poor security of agency issued documents and inadequate agency supervision of fee accounts.

50. **U. S. MARSHALL'S SERVICE:** There is a shortage of detention and handling facilities. Only 41 per cent of districts have proper ADP support. The Service lacks centralized controls, including controls over forfeited assets and the ability to account for the Support of Prisoners and Cooperative Agreement Program appropriations.

51. **ASSETS FORFEITURE FUND:** Recognizing that this program has grown twenty fold in the past four years, and recognizing that the inventory of seized properties now exceeds $1 billion, it is important that greater control and discipline be exercised within this program. For example, current procedures do not adequately tabulate the value of assets seized. Also, cash should be expeditiously placed in deposit funds. Good progress has recently been made in reforming this program.

Management needs to carefully monitor progress to assure reforms are effectively implemented.

DEPARTMENT OF LABOR

52. **SINGLE AUDIT COVERAGE:** Audit coverage under the Job Training Partnership Act (JTPA) is not in compliance with the requirements of the Single Audit Act. The adequacy of this audit coverage in providing reasonable assurance that State internal controls are properly in place needs to be assessed. In the 42 States where compliance reviews have been conducted, 14 States have not issued a State-level audit report and 40 percent of the Service Delivery Area and 30 percent of the subrecipient programs have not had an audit report issued since the start of JTPA in 1983. Whether the scope of coverage under the Single Audit Act is adequate to provide reasonable assurance of internal controls also needs to be assessed, since this coverage does not require specific financial audits of DOL programs or funds. A full analysis of deficiencies and remedies should be developed, including an explanation of how the Administration's proposed JTPA amendments would address this problem.

53. **INADEQUATE FINANCIAL SYSTEMS:** Recent OIG audits have disclosed that the Department's current financial systems are not fully integrated, contain significant information gaps and internal control weaknesses, and, as a result, produce incomplete and unreliable reports. For example, the Department's current systems have control weaknesses which have resulted in questionable unliquidated obligations of $142 million in expired ETA appropriation accounts which increased the risk of fraudulent disbursements. The Department needs to dedicate sufficient resources to resolve those financial problems expeditiously."

54. **ADP PROCUREMENT:** Stronger internal controls need to be asserted over ADP procurement. Although the establishment of the Department's Executive Computer Network has started the move to compatibility among DOL ADP systems and equipment, the policy statements and standards included in the Department's issuance Information Technology Architecture 2000 need to be pursued aggressively in the Department.

55. **OVERSIGHT OF PENSION PLANS:** While this is not an internal control issue in the same sense as the other issues raised for the Department, there are areas of pension enforcement that may bear additional scrutiny by DOL. There are approximately $1.6 trillion in assets in private retirement and benefit pension plan trusts. Approximately $700 billion of this total is in defined benefit pension plans for which the Pension

Benefit Guaranty Corporation (PBGC), established by the Employee Retirement Income Security Act of 1974 (ERISA), provides some guarantee of promised benefits. Because most plans are well funded, the PBGC is not exposed to the total liability in these plans. The Pension and Welfare Benefits Administration (PWBA) in DOL, also established by ERISA, operates an enforcement program that is intended to be a major tool in preventing future losses to pension plans from fiduciary abuse of plan funds. In addition, the Treasury Department enforces the government's standards for pension plan funding. In carrying out its oversight, the PWBA program relies heavily on independent public accountant audits. While widespread fiduciary abuse has not been determined, there is some concern that the current limited scope review used by some of the independent public accountant audits may not be as reliable for detecting fraud and abuse for government enforcement purposes as would be desirable. We understand the Department has established an internal task force to review agency enforcement programs and that pension oversight is part of the review. The result of this review should be made available to us as soon as it is completed.

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

56. **PROCUREMENT AND CONTRACT MANAGEMENT:** Eighty-eight percent of NASA's annual budget ($14 billion in 1990) goes to contractors. In many cases inadequate oversight over prime contractors has resulted in overpriced subcontracts with excessive profits. Insufficient review of mission support contractors and subcontractors causes vulnerability to mission failure and financial loss. Examples include a potential federal loss of $30M over a 15 year period due to categorization of a capital lease as a current expense and potential mission failure resulting from inadequate testing of flight hardware fasteners. There is a need for top management attention to procurement and contract management to address these problems.

57. **AUDIT FOLLOWUP:** NASA has not completed a formal audit followup system and in the past has paid inadequate management attention to timely corrective actions.

58. **FINANCIAL SYSTEMS:** Individual financial management systems, some with serious problems, are being integrated into a single agency system. Multiple payroll systems are being consolidated. There is a need to assure continuing top management attention to this financial systems improvement effort until completed.

DEPARTMENT OF STATE

59. **REHABILITATION AND MAINTENANCE OF REAL PROPERTY OVERSEAS:** Management of real property overseas is inadequate. The average age of the more than 2,100 government properties is 22 years, and the maintenance and repair of these facilities has been allowed to slide. There is a real need to make significant future investments to prevent further deterioration which could create embarrassment to the U.S. Government.

60. **OVERSEAS SECURITY PROGRAM:** Personnel and facilities abroad are being aggressively targeted for terrorism and hostile intelligence attacks worldwide by foreign governments dedicated to countering or foreign policy objectives and intercepting vital national security information. State first identified this as a material weakness in 1984. While comprehensive security, counterintelligence and embassy construction programs have been initiated, it is unclear whether adequate controls exist to manage costs and assure that objectives are effectively met within established time frames. There is a parallel concern that corrective actions take so long to complete that they become outdated.

61. **ADP OPERATIONS AND SECURITY:** The Department is heavily dependent on secure information technology and telecommunications for its basic operations. Several security and control deficiencies in information technology and telecommunications have been identified; State reported eight material weaknesses in this category, seven of them beginning in 1984. Examples are lack of back-up sites to the Department's main computer complex, and at regional administrative management centers, and protection of automated information processing systems. Current plans to correct these problems must be aggressively completed.

62. **COMPLIANCE BY ACCOUNTING AND FINANCIAL SYSTEMS:** The Department reported 52 material problems with their accounting systems. Reliable program and project financial data must be provided through State's common financial management systems, and they must meet core requirements and standards. The 1990 date for the central financial management system to be fully operational must be aggressively pursued, so that subsidiary systems can be integrated by 1991.

DEPARTMENT OF TRANSPORTATION

63. **MAJOR SYSTEMS PROCUREMENT:** FAA and Coast Guard major systems procurement capabilities may not be adequate to deal with

procurement budgets that will total $1.5 billion over the next 5 years for CG and $8.2 billion over the next 15 years for FAA. (Note these amounts refer only to major systems procurement, not to total capital programs.) Top management must oversee development of a plan and commit to a specific correction date to secure needed improvements in requirements determination, acquisition planning, specifications development, contract award, preproduction testing, contract modifications issuance, and contract administration.

64. URBAN MASS TRANSIT ADMINISTRATION: In addition to providing formula grants (approximately $1.6 billion per year) UMTA is the principal DOT provider of discretionary grants (approximately $1.1 billion per year). UMTA needs to improve the timely disbursements of grants, review and oversight of new start and rail modification projects during the planning and start-up stages, monitoring of grantees' expenditures and use of Federal funds including completion of Section 9 grants triennial review, and the closing of active projects.

65. FRAGMENTED, NONSTANDARD FINANCIAL MANAGEMENT SYSTEMS: DOT is making steady progress in consolidating its accounting systems into the Departmental Accounting and Financial Information System (DAFIS). Completion of this system is needed to provide timely, comparable program spending and other financial management data. In addition this system must be supported by consolidating and upgrading inadequate and nonstandard subsidiary systems for procurement, grants, payroll/personnel, and other administrative programs. Top management attention should assure that this weakness is corrected as scheduled by DAFIS in 1991.

66. FEDERAL HIGHWAY ADMINISTRATION: Poor practices in the employment of consultants under the highway program have continued since 1983. Top management must assure the corrective action deadline for 1990 is met.

67. MARITIME ADMINISTRATION: MarAd provides substantial financial support to U.S.- flag ocean carriers through several programs. Commitments of and disbursements of federal funds must have adequate oversight and program control to protect federal interests.

DEPARTMENT OF THE TREASURY

68. U.S. CUSTOMS SERVICE: The Customs Service is responsible for collection of Customs' duties at points of entry, as well as stopping the illegal entry of drugs and other prohibited items. The Service lacks proper fund controls and follow up to collect receivables. As of the end of FY 1988, known

delinquent debts totalled over $96 million. There is an urgent need for the Customs Service to develop adequate financial systems and employ trained personnel to run them. Customs' FMFIA problems have been reported for the past several years. While significant efforts have been made during the last year, corrective actions need to be expeditiously completed.

69. MANAGEMENT OF INTERNAL REVENUE SERVICE DELINQUENT DEBT: Controls over the Internal Revenue Service (IRS) tax administration and collection system need to be improved. Annually, IRS processes 157 million transactions amounting to $844 billion. At the end of FY 1988, delinquent taxes totalled $56.6 billion. By the third quarter of FY 1989, this total had increased to $63.4 billion. Problems have been experienced in systems modernization which have seriously affected tax return and related data processing. IRS has taken actions to reduce the growth of its delinquent debt by about $10 billion, better manage its debt portfolio, and modernize its accounting methods by using public sector techniques. The IRS needs to fully implement recommendations made by a consulting firm which studied their accounting and debt problems. Also, the tax deposit system should be reviewed to determine opportunities to improve controls and early collections.

70. DATA INTEGRITY: The Bureau of Public Debt and the Customs Service reported major problems in their accounting systems including lack of effective general ledger control, inability to reconcile accounts in a timely manner and other systems inefficiencies. Also, several other Treasury components reported problems in the linkage of receivable and property subsystems with their general ledgers. These problems have a material effect on data integrity in financial reports.

71. SYSTEM DEVELOPMENT: Improved Departmental coordination and oversight is needed over systems development in the bureaus. OMB reviews in 1989 prevented development of an unnecessary accounting system for a small office. An effective strategy is needed to assure that redundant unnecessarily customized systems are not being developed by each bureau thus wasting budgetary resources. Opportunities for external and internal cross servicing need to be thoroughly explored.

DEPARTMENT OF VETERANS AFFAIRS

72. PHYSICIAN EMPLOYMENT SCREENING: Personnel screening practices need strengthening to assure that physicians employed by the Department have adequate medical credentials and do not have

license revocations by State medical boards. A recent review disclosed that a number of physicians were employed by the Department without proper credentials.

73. **DRUG CONTROL:** Medical centers and nursing homes dispense large quantities of drugs. Scattered local systems provide poor controls. The larger issue of medical inventory controls needs review.

74. **DEPARTMENTAL FOLLOWUP SYSTEMS:** Department managers have not always taken prompt action to correct problems identified by the A-123 internal control reporting system and by Office of Inspector General audit reports. Several internal control material weaknesses have been awaiting corrective action for five years or more. Also, a recent Office of Inspector General audit report shows that the recommendations for about 34 percent of the audits reviewed were not being timely or effectively implemented. This situation demonstrates the need for an adequate system to follow up on corrective actions.

75. **IMPROVE OVERSIGHT AND REVIEW IN THE VA LOAN GUARANTY PROGRAM:** There is no evidence that the VA Loan Guaranty program is faced with the problems that have recently surfaced in HUD's FHA program. However, because of the programs' similarities, the Secretary should consider a concentrated review of that program's internal controls and operations in the very near term.

    GAO has found that VA has underutilized alternatives to foreclosure which can reduce veteran's debt, and in turn, the debt owed the Government. The VA loan guaranty program managers should work with private lenders to insure compliance with VA guidance on credit underwriting and due diligence requirements which have a direct bearing on debt creation.

76. **PROCEDURES FOR CONSTRUCTING HEALTH CARE FACILITIES:** During FY 1989, VA received an appropriation of $363 million to construct health care facilities. The VA construction program needs an overall approach to construction planning to improve efficiency and effectiveness. Needs analysis should be performed that realistically assesses the program delivery needs of each facility, as well as cost alternatives. This weakness has remained unresolved since 1983.

77. **COMPENSATION AND PENSION:** The integrity of the compensation and pension programs requires further assurance. Entitlement decisions and benefit authorizations have not always been appropriate or correct. Office of Inspector General wage matches and audits have disclosed over $53 million in overpayments and over 6,000 cases referred for further investigation. Strengthened procedures and VA access to

Internal Revenue Service data are needed to ensure the accuracy of information provided by VA beneficiaries.

78. **REVIEW OF INTERNAL CONTROLS:** The Deputy Secretary has placed a high priority on evaluating the internal control process. A timetable should be established to carry this out as soon as possible.

AGENCY FOR INTERNATIONAL DEVELOPMENT

79. **FINANCIAL MANAGEMENT SYSTEMS AND OPERATIONS:** AID's primary accounting system (Financial Accounting and Control System - FACS) was 40 percent complete by 1989. However, the discovery of serious internal control problems, highlighted by the uncovering of a $1.2 million embezzlement scheme and serious technical problems in FACS implementation, necessitates a fundamental reassessment of that plan. Other subsidiary systems improvements, dependent on FACS, may be seriously impacted as well, including the Mission Accounting System (MACS), the Contract Information Management System (CIMS), and the Housing Guaranty Information System. This will delay full integration of AID's financial systems until 1994, well beyond the Administration's goal of having all agency systems integrated by 1992.

80. **AUDIT COVERAGE OF AID PROGRAMS AND ADMINISTRATIVE OPERATIONS:** A recent Inspector General report found that infrequent audits at overseas missions increased the risk of fraud, waste and mismanagement. While additional staff resources have been provided to the Inspector General, other steps need to be taken to assure compliance with the FMFIA and OMB Circular A-123.

81. **ADP SECURITY:** A recent General Accounting Office report indicated that AID has 24 computer systems containing sensitive information. AID's own recent review of its automated data processing security plan revealed that potentially damaging vulnerabilities exist in the program to manage computer resident information, particularly in the financial management area.

82. **STAFFING LEVELS FOR ADMINISTRATIVE MANAGEMENT:** An increased level of accountability is required for AID-managed funds to respond to concerns of Congress, AID management and OMB. AID will continue to study its accountability systems and develop a plan to correct any deficiencies over the course of 1990.

COMMISSION ON CIVIL RIGHTS

83. **IMPROVED CONTROL OF HIRING, TRAVEL MANAGEMENT AND RECORD KEEPING:** In May 1988, the General Accounting Office completed a wide-ranging review of Commission management practices. The report cited problems in hiring controls, travel management and record keeping. Specific details are needed with regard to corrections completed or planned.

EXECUTIVE OFFICE OF THE PRESIDENT

84. **A COMPREHENSIVE INTERNAL CONTROL PROGRAM IS NEEDED:** The 1988 FMFIA submission for EXOP seems to be heavily oriented toward internal reviews of administrative activities particularly financial functions. Vulnerability assessments and internal control reviews must encompass all administrative and programmatic activities of the EXOP. Reviews need to be expanded to include areas such as:

    - Planning and control of ADP activities including security reviews and adequacy of disaster recovery plans.
    - Reviews of procurement policies, practices and controls to prevent fraud, waste, and abuse.
    - Reviews of building security to ensure that unauthorized access is effectively prevented.
    - Reviews to ensure that controls are adequate: (a) to prevent personnel from engaging in unauthorized activities, or (b) to detect serious conflicts of interest arising from their duties.
    - Reviews to ensure that programmatic missions are being carried out efficiently and effectively, and that controls are adequate to prevent abuse of policy development responsibilities.

85. **INTERNAL AUDIT COVERAGE IS NEEDED:** Internal audits are not conducted within the EXOP. Although the office is legally exempt from establishing an Inspector General, OMB endorses internal audit programs for other agencies. To be consistent with this endorsement, EXOP should administratively establish audit coverage.

FARM CREDIT ADMINISTRATION

86. **INADEQUATE FINANCIAL SYSTEMS AND PROPERTY CONTROLS:** The Inspector General recently reported that the financial accounting and property controls have been deficient for a long time. The Agency has not had an integrated system but an aggregation of discrete tasks, each of which has functioned without any meaningful awareness or interaction with other tasks. This situation has not only been inefficient but ineffective, in that many fundamental controls have not been installed.

FEDERAL EMERGENCY MANAGEMENT AGENCY

87. **INADEQUATE FINANCIAL MANAGEMENT SYSTEM:** The agency's core financial management system, the Financial Accounting and Reporting System (FARS), is not integrated with subsidiary systems. For example, disaster assistance information, Federal insurance information and property value data are not integrated into FARS. In addition, external reports are not produced by FARS and the U.S. Standard Ledger has not been implemented.

88. **INADEQUATE IMPLEMENTATION OF THE INTERNAL CONTROL PROGRAM:** The agency's ten regional offices have not implemented the required internal control program set forth in OMB Circular A-123. Although risk assessments are currently planned for FY 1990, no internal control reviews of high risk areas are scheduled for this period. Given the recent natural disasters which have occurred, the agency lacks assurance that appropriate controls are in place and are being followed. The agency needs to focus on conducting internal control reviews of its programs and not confine the program to financial and administrative systems.

GENERAL SERVICES ADMINISTRATION

89. **INADEQUATE OVERSIGHT OF MAJOR SYSTEMS DEVELOPMENT PROJECT:** The Agency reported the collapse of a major system development project (STRIDE) in the 1988 FMFIA report to the President. The Inspector General in reviewing the history of the project which cost $120 million over a five year period, concluded that (i) the project was virtually impossible from its conception given that a logical progressive approach to the development of STRIDE was not utilized, (ii) quality controls were not in place, (iii) progress reports to management were inaccurate and (iv) project oversight was ineffective. GSA

is now undertaking major systems development in the PBSIS and GSAS projects. GSA must have positive assurance there is no repeat of its systems development failure.

90. **NEED FOR MAJOR PROGRAM REVIEWS UNDER THE INTERNAL CONTROL PROGRAM:** The Acting Administrator's report indicates major material weaknesses may not have been reported in previous years because of the design of the agency's internal control review program. We have serious concerns that major programs may not have been subjected to internal control reviews. GSA operates a number of programs involving areas which have been the subject of abuse in other agencies. We suggest the following program areas be reviewed:

(a) Leasing Program - GSA leases one-sixth of the available commercial building space in Washington DC but continues to pay top rates for such leases. A review of the program should be conducted to ensure policies are not only adequate but are being followed.

(b) Opportunity Purchase Program - Recent selections under this program indicate that selection criteria may not have been followed.

(c) Other major programs such as procurement and fleet maintenance should also be reviewed.

NATIONAL CREDIT UNION ADMINISTRATION

91. **ASSET LIQUIDATION MANAGEMENT CENTER:** The newly established Center which is responsible for managing an inventory of property and assets from failed or troubled credit unions will require close attention to assure that adequate controls are in place to prevent fraud, abuse and mismanagement. Initial property inventories from credit unions, management of those assets pending sale, and actual disposition activities must be closely monitored to minimize potential for mishandling and loss of control. Detailed property unit management and disposition plans that have been developed should assure maximum sales proceeds (at minimum cost) compared to market value.

92. **INTERNAL CONTROL PROGRAM:** Action has already been initiated to correct deficiencies in the internal control process, such as inadequate documentation of management reviews. Followup reviews need to be conducted to assure that managers adequately document all assessments.

NATIONAL LABOR RELATIONS BOARD

93. **SINGLE INTEGRATED ACCOUNTING SYSTEM:** The existing accounting system does not provide for user access to current accounting data until month end nor is it adequately linked to other financial systems, such as budget formulation. Reviews of other agency systems for cross servicing or cloning need to be completed. This issue is not resolved until a new system is installed and operating or cross servicing arrangements are completed and full systems linkage has been successfully demonstrated.

94. **RECONCILIATION OF NON-EXPENDABLE INVENTORY ASSETS:** Inventory assets are not fully reconciled with appropriate accounting system records and the new computerized inventory system has not been fully implemented. Management estimates that reconciliation will be completed by April 1990. This issue is not resolved until the reconciliation is complete and a new system is installed that meets user needs.

PEACE CORPS

95. **FINANCIAL MANAGEMENT SYSTEMS:** Financial management systems have insufficient management controls to assure prompt and accurate transactions and correctness of data, including inaccuracies in the sub-system for personal property inventory and lack of controls over loss of funds or fraud in the sub-system for disbursing volunteer allowance payments.

96. **CONTROLS AT OVERSEAS POSTS:** The efficiency, compliance with policies and guidance for internal controls and accountability at overseas posts needs to be examined, as the Peace Corps Director indicates in his letter.

PENSION BENEFIT GUARANTY CORPORATION

97. **COORDINATION OF INFORMATION ON PENSION PLANS:** Regulatory enforcement and oversight of private pension plans has been identified to the Department of Labor as an area where there is a high risk that there will be abuse of the assets of some private pension plans. We recognize that the Labor Department's Pension Welfare and Benefits Administration is responsible for regulatory oversight of the fiduciary behavior of pension plan trustees and that the Internal Revenue Service in Treasury enforces the government's funding standards for defined benefit pension plans. To enhance their programs, any information concerning potential risks of pension fund abuse

or inadequate plan funding discovered by the your staff or your Inspector General should be shared with these other agencies. Expedient channels for early warning should be arranged.

98. REVIEW OF PROCUREMENT POLICIES AND PROCEDURES: The nature of the procurement function makes it vulnerable to generic weaknesses. While no specific problems were reported, a thorough review of your procurement polices, procedures and cycle should be performed to provide assurance that no unknown weaknesses or risks remain undetected.

SECURITIES AND EXCHANGE COMMISSION

99. PROCESSING EQUAL OPPORTUNITY COMPLAINTS: Problems in the lengthy processing of EEO complaints were reported as corrected; however, specific remedies have not been reported. The settlement agreement which emanated from Broderick vs Ruder provided for an independent study of the program. This issue is not resolved until the study is complete and its recommendations are implemented.

100. COMPUTER CONTINGENCY PLANNING: The absence of a long-term disaster recovery plan to maintain continuity of computer operations in the event of a disaster increases the risk to Commission programs. While an interim plan has been developed, this issue is not resolved until a comprehensive analysis has been completed, firm back up assistance has been arranged and the comprehensive plan has been implemented.

101. MANAGEMENT OF ADP SYSTEMS DEVELOPMENT PROJECTS: The management of systems development projects needs to be strengthened. Specifically, systems planning (e.g., definition of user requirements, cost benefit analyses, etc), conflict resolution and contract administration weaknesses require attention. These issues not only affect the success of current automation efforts, but jeopardize future improvements as well. Plans to bring systems to state-of-the-art technology require improved management planning and specific assignment of project accountability.

SMALL BUSINESS ADMINISTRATION

102. SMALL BUSINESS DEVELOPMENT CENTER (SBDC) CONTROLS: Some SBDCs lack internal controls and acceptable accounting methods to track receipt and disposition of program income. Procedural improvements must be made to forestall future abuse. However, a restrictive clause in the agency's

appropriations for 1988 and 1989 prohibits necessary SBA rule making to direct corrective action.

103. **PORTFOLIO MANAGEMENT/LIQUIDATION:** Staff are unable to handle the increasing volume and complexity of workload. Necessary delegations to participating lenders raise further control problems.

104. **SMALL BUSINESS INVESTMENT COMPANY (SBIC) LIQUIDATION ACTIVITIES:** Accounts in liquidation status are inadequately supervised and may result in large federal liabilities. Documentation, overview, and control procedures are not in compliance with internal control standards.

UNITED STATES INFORMATION AGENCY

105. **FINANCIAL MANAGEMENT SYSTEMS AND OPERATIONS:** The agency's financial management systems and operations pose a number of problems, including: (1) noncompliance with FMFIA and OMB Circulars A-127 and A-130; (2) insufficient controls in subsidiary systems, such as property management; (3) funds control problems in imprest funds and in the Voluntary Visitors Program; (4) lack of internal and fiscal control requirements for the Fulbright Binational Commissions; and (5) lack of overall integration of the Agency's systems.

UNITED STATES SOLDIERS' AND AIRMENS' HOME

106. **FINANCIAL AND MANAGEMENT CONTROLS:** Reports from the Army Inspector General, the House Appropriations Committee, and OMB indicate evidence of weak financial and management controls in a number of areas, including: (1) inadequate cost allocation to program activities; (2) poor accounting records and data accuracy; and (3) inadequate contract administration. Overall attention to the requirements of the Federal Managers' Financial Integrity Act (FMFIA) and OMB Circulars A-123 and A-127 has been insufficient to assure proper utilization of resources. Cross-servicing with another Federal agency for key financial operations should be considered.

WRITTEN QUESTIONS FROM SENATOR SANFORD TO MR. DARMAN AND THE RESPONSES

Question 1. Mr. Darman, how does your deficit figure differ from the increase in debt subject to the limit? What makes up the billions of dollars difference in the two figures?

Answer. The primary difference between the Government deficit and the increase in debt subject to limit is the increase in debt held by Government accounts. The Government deficit approximately equals the increase in debt held by the public, while the increase in debt subject to limit includes not only most of the increase in the debt held by the public but also most of the increase in the debt held by Government accounts.

The budget is composed of two groups of funds, Federal funds and trust funds. Federal funds deficits must generally be financed by borrowing, either by selling securities to the public or by issuing securities to Government accounts. Trust fund surpluses are almost entirely invested in these securities, which are classified as Federal debt, and trust fund holdings include most of the debt held by Government accounts. Almost all of the debt securities issued by the Treasury to finance the Federal funds deficit, including the securities issued to Government accounts, is subject to the statutory limit. Thus the increase in the debt subject to limit is determined principally by the Federal funds deficit. So long as the trust fund surplus is large, the Federal funds deficit will be much more than the total Government deficit; and the increase in debt subject to limit will be much more than the increase in debt held by the public.

The table below explains these differences for FY 1991. At the end of 1990, the debt subject to limit is estimated to be $3,071.1 billion. The proposed 1991 deficit, on a unified budget basis, is projected to be $63.1 billion, which is the net of a $153.0 billion trust funds surplus and a $216.1 billion Federal funds deficit. About $13.7 billion of the Federal funds deficit is financed by means other than borrowing, including an increase in checks outstanding and seigniorage on coins. In addition, the debt subject to limit is affected by two further factors. Some Federal funds and deposit funds are expected to increase their holdings of Federal debt by $3.4 billion, and $0.4 billion of the total increase in Federal debt is not subject to limit. In sum, the debt subject to limit is estimated to increase by $205.5 billion, bringing the total to $3.276.6 billion. This increase in debt subject to limit is $146.9 billion more than the increase in debt held by the public ($58.6 billion).

Increase in debt subject to limit: 1991

[In billions of dollars]

1990 debt subject to statutory limit	$3,071.1
1991 increase in debt subject to statutory limit:	
Unified budget deficit (+)	63.1
Exclude trust funds surplus	153.9
Federal funds defict (+)	216.1
Amount financed by means other than borrowing	−13.7
Increase in Federal debt held by Federal funds and deposit funds	3.4
Federal debt issued but not subject to limit	−0.4
Equals increase in debt subject to limit	205.5
1991 debt subject to statutory limit	3,276.6

Question 2. Why has President Bush not proposed to change the Federal Budget to give more attention to our bottom-line numbers and require a deficit figure to reflect the bottom line—the amount we actually increase the debt subject to the limit?

Answer. The bottom line of the present Federal budget is the unified budget deficit, which approximately corresponds to Federal borrowing from the public. Borrowing from the public increases the volume of securities sold in the credit market and tends to raise the level of interest rates. It is financed by the saving of other sectors of the economy, which reduces the funds available for private investment; or by the saving of the rest of the world, which builds up the debt of the United States abroad. The budget deficit, or borrowing from the public, is therefore a fundamental concern of Federal budget policy.

Question 3. President Bush's budget projects an increase in total receipts from 1990 to 1991 of nearly $97 billion.

Is the Social Security Surplus included in that figure?

What amount of the total receipts is Social Security (Old Age and Disability)?

What amount of your projected total receipts for 1991 are receipts from other trust funds?

Is there any hidden interest included total receipt figure? By that I mean interest that Treasury pays to the trust funds and counts as a receipts and does not count in the net interest figure generally used, but would be included in the gross interest figure. If so, what amount?

Answer. Governmental receipts increase by $96.8 billion from 1990 to 1991. Social Security receipts are included in that total, aaccounting for $29.1 billion of the increase from 1990 to 1991. Other trust funds account for an additional $15.7 billion of the 1990 to 1991 difference.

There is no hidden interest in the governmental receipts total. Interest Treasury pays to trust funds is included as an outlay in the net interest function. (The interest received by trust funds is also included in the net interest function.)

Question 4. Do you view Social Security as a retirement pension program? How does Social Security differ from private pension programs? How does Social Security differ from other federal retirement programs?

Answer. Social security is generally considered a social insurance program, similar to private pensions but with some significant differences. Social security provides benefits to replace lost income due to retirement, disability, or death. Social security pays benefits to workers in retirement and during a disability, with additional payments to dependent family members (spouses, children, parents). Benefits are also paid to survivors (widows, widowers, children, parents) if a worker dies and the family was dependent on that income. Social security benefits are calculated in part by using the worker's earnings during his or her working years, but the benefit formula is progressive, favoring low wage earners over high wage earners. Most private pensions provide benefits only to workers and only in retirement. The benefits are more directly related to the worker's wages (like an annuity) than social security.

With respect to Federal retirement programs, those that are integrated with social security (like FERS) more closely resemble private pensions because they provide benefits in addition to social security. Other Federal retirement programs serve many different populations (judges, foreign service, etc.) any vary greatly in the purposes and the kinds of benefits provided, with some similarities to both social security and private pensions.

One other Federal program, railroad retirement, is an anomaly in that it is the only private industry pension system administered by the Federal government. Railroad retirement actually has two components: a social security equivalent component which is virtually identical to the social security program; and an industry pension component that is the equivalent of private pensions in other industries.

Question 5. Do we treat Social Security and our other federal retirement programs in the Federal Budget the same way the private sector, a private corporation must account for its retirement program? If not, what is the justification for this double standard? Why is it alright for the Federal Government to mask deficit with pension funds and illegal for the private sector?

Answer. The income statement of a private corporation is designed to measure the firm's profit. Profit is the difference between the revenue for the year and the expenses incurred in earning that revenue, including the expense of accruing pension liabilities with respect to the firm's employees.

The Federal budget, in contrast, does not measure profit. It proposes an allocation of resources among particular programs for the purpose of meeting public policy goals. The budget generally measures transactions with the public on a cash (or cash-equivalent) basis, because this is relatively effective in measuring the allocation of resources and controlling expenditure. It includes social security and the Federal employees retirement programs, because they are part of the Government. A full accounting of Federal transactions with the public, and therefore the full effect of the Federal Government on the allocation of resources among Federal programs, must necessarily include them.

This year for the first time the budget document supplements this basic budgetary accounting by an extended analysis of the unfunded annuities for social security, medicare and Federal employee retirement programs (Part VI-A, "Acknowledging Inherited Claims: Accounting for Debt and Unfunded Annuities"). It discusses the actuarial deficiencies of these programs, the demographic pressure the extended outlook over the next 75 years. Based on this analysis, the budget proposes a Social Security Integrity and Debt Reduction Fund to preserve the social security trust fund buildup for its intended purpose—the payment of benefits to the baby boom generation.

Question 6. Given the demand for this (Section 515 rental development) program and the acknowledged need for decent housing in rural areas, what is the rationale for this reduction?

Answer. The President's '91 Budget proposal *increases* the number of families assisted by FmHA housing programs. While it is true that direct loans for rental housing construction were reduced, they were more than compensated for by a new program of housing vouchers. The proposed FmHA housing program saves Federal funds while actually increasing assistance to low income rural families.

Substandard housing and affordability are the two most important problems facing low income, rural households. As shown in recent reports, 23% of all rural units are inadequate compared to Federal standards. An additional 72% of all households are paying a disproportionate amount of their income for housing, also known as a high rent-burden.

The Federal government currently asks the FmHA to build enough units to solve both problems. This is not a cost effective strategy, however. Families with high rent-burdens require income assistance, not a new apartment. Even after subsidizing new construction with a 1% long term loan and investor income tax credits, many units will be too expensive for low income families. Subsidized construction alone does not solve all the problems of housing affordability.

FmHA's current rental construction program is capable of aiding very low income households only because it can offer rental assistance payments (RAP) when needed. These payments are voucher equivalents except that they force the recipient to live in one particular building. The reduction in housing construction loans simply breaks this tie for a proposed 8,000 families. With a voucher, affordability problems will be eliminated while offering greater choice for the household.

To better combat the problems of substandard housing, the '91 Budget proposal includes greater targeting of new construction to areas with high levels of substandard housing and very low incomes. Recent research indicates that most remaining substandard units are concentrated in select counties, not scattered randomly across the nation. As a result, continued funding for new construction will finally ease the long standing problems of inadequate rural housing.

Question 7. Given the fact that there is a proven need for at least three times the appropriation for this program (Section 515 rental development), does it make sense to reduce the budget by one-third?

Answer. Clearly, the Administration agrees that low income rural families require continued rental housing assistance. The President's Budget proposal inclues assistance for some 46,000 units, or 1,300 units more than assisted in FY90. The difference in the FY91 proposal is the manner in which families receive Federal assistance and corresponding budget savings. Unlike past year programs, the President proposes use of housing vouchers to replace a portion of the direct loans dedicated for rural rental housing development.

As discussed in question #1, rural rental housing problems center on housing affordability and suitability. The government possesses two different tools to eliminate these problems: subsidized construction and income assistance. Neither tool can effectively assist all communities since housing markets vary radically throughout rural Ameria. Only with both tools can the FmHA hope to effectively ease housing problems for low income families.

The amount of subsidized construction required in rural areas is difficult to calculate. At one extreme, the government could build no more units and rely entirely on income transfers with the expectation that private developers will build new housing where necessary. At another extreme, the government coould build a new, lower cost apartment for every household who currently pays more than 30% of their income in rent. The amount of required construction can be determined only after the government decides the "who's" and "how's" of its housing policy.

The estimated $2 billion backlog in FmHA applications is certainly towards the upper end of the scale for new construction demand in FY91. First, this figure does not allow for one project per housing market. Section 515 applications will compete for new locations and will double, triple, and quadruple count the number of eligible households. Second, FmHA applications are only a measure of financial feasibility for Section 515 projects. If tax credits increased, demand for loans would increase, but demand for housing certainly would not change.

In this light, the Administration's proposal for $391 million in FY91 is a reasonble amount of new housing construction. An additional 8,000 familes would receive immediate assistance through an FmHA housing voucher program. Further, over the course of the budget proposal, construction would continue, totaling over $1.6 billion by FY95.

Question 8. In light of this demand (for Section 502 homeownership loans), what is the rationale for reducing this program?

Answer. Unlike the FmHA rental programs, the '91 Budget proposal includes modest reductions in loan making for the Section 502 homeownership program. The effect upon potential homeowners will be small, however, given the build-up of RTC surplus properties and continued credit growth assisted by Federally created secondary markets.

Even in the President's Budget proposal,FmHA will continue to offer one of the most heavily subsidized housing programs offered by the federal government. FmHA mortgages vary according to the borrower's income and can be as low as 1%. In addition, low income borrowers do not need a downpayment to obtain FmHA financing. The cost of such assistance is steep, however. In FY89, interest costs (net of loan payments) were in excess of $1.4 billion.

Question 9. Given the tremendous demand for loans from low-income households, why is the Administration reducing the direct loan authority for low-income households in order to fund a guaranteed loan program for above moderate-income households?

Answer. The President's rural housing proposal for FY91 includes moderate increases in rental units compared to additional housing loans. Rather than moving Federal subsidies from low-income poor to above moderate-income households, the net effect is to assist those persons who could not qualify for any housing loan.

The FY91 Budget proposal is not intended to remove low-income families from FmHA assistance. Of the $594 million in loan guarantees, one-half will be provided with an interest rate subsidy averaging 5%. In addition, nearly all direct loans are expected to carry subsidized interest rates. In this manner, FmHA can serve low and very low-income borrowers at the least cost to government.

A count of subsidized units demonstrates that the Administration's proposals do no substantially shift FmHA away from low-income households. In FY90, roughly 44,745 households were served by FmHA, including 1,750 unsubsidized units. The FY91 proposal provides for 46,065 units. Of these units, some 7,340 unsubsidized units will be provided. As a result, only 4,270 fewer subsidized units are provided in the FY91 Budget.

Question 10. Given the precarious nature of the (banking) industry, is it realistic to think that a new government program, which will ask lenders to make guaranteed loans to low and very low-income families, makes sense?

Answer. While rural communities have been hard hit by the S&L crisis, a new FmHA guaranteed program can be successfully implemented by FmHA. There are a number of positive factors favoring use of guarantees, including:

Diminished risk for lender.—FmHA guarantees will typically ensure 80% of the loan. This reduces the bank's exposure to risk on its entire loan portfolio, a particularly attractive feature for rural banks and S&L's;

Increased lender liquidity through secondary markets for guarantees.—Guaranteed loans also increase the liquidity of a financial institution's portfolio. Many banks currently remove the guaranteed portion of FmHA farm loans and sell them to investors. Sale proceeds may then be used for further loan-making;

Interest subsidies further reduce loan risk.—One half of FmHA guarantees will be provided with interest subsidies, averaging 5%. Continued government subsidies ensures banks of an on-going cash flow and makes low income FmHA borrowers much more viable credit risks;

Added competition in rural credit markets.—Growth of interstate and branch banking is providing a larger and more diversified portfolio for rural lenders. With added financial breadth, rural institutions can more freely participate in programs such as FmHA guarantees.

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO MR. DARMAN AND THE RESPONSES

Question 1. How much do outlays grow in the OMB baseline between fiscal years 1990 and 1991 and between fiscal years 1990 and 1995?

Answer. Outlays grow from $1,194.8 billion in 1990 to $1,241.0 billion in 1991, or $46.2 billion, in OMB's G-R-H baseline. The OMB G-R-H baseline however has two major anomalies: the food stamps program is assumed to expire and funding for the decennial census is included in all years. When these two anomalies are adjusted for outlays grow by $62.0 billion between 1990 and 1991.

Outlays grow by $249.6 billion from 1990 to 1995 in OMB's G-R-H baseline and by $272.6 billion for the same years under the adjusted baseline.

[Outlays in billions]

	1990	1991	1995	1990 versus	
				1991	1995
G-R-H baseline	1,194.8	1,241.0	1,444.5	46.2	249.6
Adjusted G-R-H baseline	1,194.8	1.256.8	1,467.4	62.0	272.6

Question 2. How much of this growth is attributed to:
Domestic discretionary inflation?
Defense inflation?
Interest?
COLA's?
Beneficiary growth in entitlements?
Health care costs and utilization?
Other growth?

Answer. The increase in outlays from 1990 to 1991 in the adjusted baseline can be attributed as follows:

[In billions of dollars]

Defense:	
Inflation	8.1
Other	2.0
Nondefense discretionary:	
Inflation	4.6
Other	6.5
Interest	−1.3
COLAs for indexed entitlements	10.5
Health entitlements (including price, utilization and caseload)	12.9
Other entitlement growth (including caseload)	18.4
All other (undistributed offsetting receipts and asset sales)	0.4
Total	62.0

The increase in outlays from 1990 to 1995 in the adjusted baseline can be attributed as follows:

[In billions of dollars]

Defense (largely inflation)	56.1
Nondefense discretionary (largely inflation)	38.6
Interest	−24.5
COLA's for indexed entitlements	69.7
Health entitlements (including price, utilization and caseload)	50.3
Other entitlement growth (including caseload)	89.8
All other (undistributed offsetting receipts and asset sales)	−7.4
Total	272.6

ANTI-DRUG SPENDING

Question 3. The President's budget and the National Drug Control Strategy state that budget authority for anti-drug programs totalled $6.302 billion in FY 1989. Just four months ago, in the first National Drug Control Strategy, the FY 1989 enacted total was estimated to be $5.669 billion. Please provide a detailed explanation, including both budget authority and outlays, of the sources of the differences between the two estimates.

Answer. In conjunction with ONDCP and the respective agencies, OMB has made a number of technical adjustments to the 1989 funding level shown in the first National Drug Control Strategy. In general, these adjustments reflect efforts to account more accurately for Federal drug funding. In fact, in its conference report for the 1990 Transportation Appropriations bill, Congress instructed the Administration to present ". . . more accurate anti-drug funding data . . ." to Congress.

We added several new programs to the 1991 drug budget. These are programs which have a drug component but for which no estimate of spending was previously available. These new programs—Job Training Partnership Act (DOL) (+$33M), Health Care Financing Administration (Medicaid/Medicare) (+$140M), Centers for Disease Control (+$20M), Federal Law Enforcement Training Center (+$18M), U.S.

Secret Service (+$2M)—added about $203 million in budget authority to the previous estimate.

Technical adjustments were also made to previously under-reported drug programs. In Veterans Affairs, the costs of medical care for veterans for whom drug abuse is a secondary diagnosis are now included (+$148 M). The Department of Defense revised its estimates of drug-related efforts to reflect the greater use of active duty forces, as well as $65 million in emergency aid provided to Colombia (+$81M). Education added the drug-related component of its vocational rehabilitation program (+$22M). The FBI's efforts are better accounted for by including the proportionate share of other activities which support their drugs-only program (+$74M). The Bureau of Prisons increased the drug portion of 1989 funding for prison construction to reflect the projected drug-related inmate population at the time 1989 projects are scheduled to become operational (+$157M). The Customs estimate has been revised to include actual expenditures on inspection and control, as well as additional spending from its forfeiture fund (+$81M). The Bureau of Alcohol, Tobacco, and Firearms now counts drug-related firearms investigations, rather than just its participation in the Organized Crime Drug Enforcement Task Forces (+$80M). Finally, the estimate for the Alcohol, Drug Abuse, and Mental Health Administration was revised downwards (−$175M), because previous estimates included some funding targeted for alcohol, rather than drug, abuse. Estimates for several other accounts were adjusted slightly to reflect the availability of better data.

As estimates of budget authority change, so have outlay estimates. In addition, outlay estimates for drug accounts have changed because agencies have closed their books for FY 1989 and have determined final outlay figures.

Additional adjustments can be expected as OMB, the agencies, and ONDCP continue to refine estimates of drug-related expenditures.

Background: See table showing the differences in 1989 estimates by agency.

1989 FEDERAL DRUG CONTROL PROGRAMS BY AGENCY
(BA and Outlays in Millions)

AGENCY		Sept. 1989 Strategy I 1989 Estimate	Jan. 1990 Strategy II 1989 Actual	Strategy II Increase/ Decrease
ACTION	BA	7.9	10.1	2.2
	O	5.0	3.0	(2.0)
AGRICULTURE	BA	6.5	6.5	0.0
	O	6.5	6.5	0.0
DEFENSE	BA	420.3	501.6	81.3
	O	410.1	410.0	(0.1)
EDUCATION	BA	354.5	376.3	21.8
	O	210.9	292.3	81.4
HEALTH & HUMAN SERVICES				
ADAMHA	BA	890.8	716.0	(174.8)
	O	732.6	680.0	(52.6)
Centers for Disease Control	BA	0.0	20.0	20.0
	O	0.0	18.0	18.0
Health Care Financing Administration	BA	0.0	140.0	140.0
Medicare/Medicaid	O	0.0	140.0	140.0
Other (Food & Drug Admin/Family Support				
Admin/Human Development Services	BA	55.4	58.7	3.3
Indian Health Service)	O	26.4	58.0	31.6
		======	====	======
TOTAL, HHS	BA	946.2	934.7	(11.5)
	O	759.0	896.0	137.0
HUD	BA	8.0	8.2	0.2
	O	3.7	0.0	(3.7)
INTERIOR	BA	9.7	13.4	3.7
	O	11.5	13.2	1.7
JUSTICE				
Bureau of Prisons	BA	630.7	787.5	156.8
	O	503.9	478.0	(25.9)
DEA	BA	551.2	542.9 _/1	(8.3)
	O	499.7	509.2	9.5
FBI	BA	135.6	209.9 _/1	74.3
	O	136.3	223.8	87.5
Forfeiture Fund	BA	326.0	271.6	(54.4)
	O	145.5	242.0	96.5

1989 FEDERAL DRUG CONTROL PROGRAMS BY AGENCY
(BA and Outlays in Millions)

AGENCY		Sept. 1989 Strategy I 1989 Estimate	Jan. 1990 Strategy II 1989 Actual	Strategy II Increase/ Decrease
INS	BA	113.2	126.4 _/1	13.2
	O	108.4	128.0	19.6
Office of Justice Programs	BA	182.8	185.6	2.8
	O	120.4	184.4	64.0
Support of Prisoners	BA	63.4	72.1	8.7
	O	59.3	74.0	14.7
U.S. Attorneys	BA	143.4	134.0 _/1	(9.4)
	O	141.7	133.0	(8.7)
U.S. Marshals	BA	126.4	124.4	(2.0)
	O	122.9	120.0	(2.9)
Other Justice	BA	16.6	16.2	(0.4)
(Criminal Div, Tax Div, Interpol)	O	15.8	12.2	(3.6)
		======	====	======
TOTAL, JUSTICE	BA	2,289.3	2,470.6	181.3
	O	1,853.9	2,104.6	250.7
LABOR				
Job Training Partnership Act	BA	3.2	36.2	33.0
	O	3.0	36.0	33.0
Other	BA	2.5	2.4	(0.1)
	O	0.4	2.4	2.0
		======	====	======
TOTAL, LABOR	BA	5.7	38.6	32.9
	O	3.4	38.4	35.0
OFFICE OF THE PRESIDENT				
Office of National Drug Control Policy	BA	3.5	3.5	0.0
	O	2.6	2.1	(0.5)
Special Forfeiture Fund	BA	0.0	0.0	0.0
	O	0.0	0.0	0.0
		======	====	======
TOTAL, ONDCP	BA	3.5	3.5	0.0
	O	2.6	2.1	(0.5)
INTERNATIONAL	BA	155.7	141.8	(13.9)
STATE/AID	O	149.2	120.0	(29.2)
TRANSPORTATION				
Coast Guard	BA	632.9	633.5	0.6
	O	601.5	602.0	0.5

1989 FEDERAL DRUG CONTROL PROGRAMS BY AGENCY
(BA and Outlays in Millions)

AGENCY		Sept. 1989 Strategy I 1989 Estimate	Jan. 1990 Strategy II 1989 Actual		Strategy II Increase/ Decrease
Federal Aviation Administration	BA	4.3	7.5		3.2
	O	4.3	7.4		3.1
National Highway & Traffic Safety Administration	BA	0.4	2.0		1.6
	O	0.2	1.0		0.8
		======	====		======
TOTAL, TRANSPORTATIO	BA	637.6	643.0		5.4
	O	606.0	610.4		4.4
TREASURY					
Bureau of Alcohol, Tobacco & Firearms	BA	8.8	89.0	_/1	80.2
	O	8.6	93.8		85.2
Customs Service	BA	444.0	525.2	_/1	81.2
	O	435.0	493.1		58.1
Federal Law Enforcement Training Center	BA	0.0	17.7		17.7
	O	0.0	17.7		17.7
Internal Revenue Service	BA	68.3	68.3	_/1	0.0
	O	68.3	68.0		(0.3)
Secret Service	BA	0.0	2.3		2.3
	O	0.0	2.0		2.0
		======	====		======
TOTAL, TREASURY	BA	521.1	702.5		181.4
	O	511.9	674.6		162.7
U.S. COURTS	BA	209.0	208.8		(0.2)
	O	188.1	188.0		(0.1)
VETERANS AFFAIRS	BA	93.9	242.0		148.1
	O	93.6	238.0		144.4
		======	====		======
TOTAL	BA	5,668.9	6,301.6		632.7
	O	4,815.4	5,597.1		781.7

1/ OCDETF funding spread in individual agency accounts in 1989.

Question 4. The budget accompanying the revised Bush budget submitted in February 1989 assumed that FY 1981 anti-drug spending budget authority was $1.138 billion. On page 111 of the FY 1991 budget, a table lists the FY 1981 budget authority total at $1.4 billion. Please provide a detailed explanation for both budget authority and outlays, of the revised estimate.

Answer. The February 1989 estimate of 1981 drug funding was revised to provide a figure comparable to the 1991 estimate. Since last year, a number of technical adjustments have been made to the drug funding estimates. For example, several accounts that had some drug control component, but which were not previously tabulated as such, are now represented. These include: the Health Care Financing Administration, U.S. Courts, Job Training Partnership Act, Centers for Disease Control, Vocational Rehabilitation, Federal Law Enforcement Training Center, and the U.S. Secret Service.

In addition, other accounts have been adjusted to account for previous under-reporting, such as the Bureau of Alcohol, Tobacco, and Firearms, the Department of Veterans Affairs, and the FBI.

The adjustment to the 1981 estimate (+$306 million BA, +$292 OL) repesents an attempt to provide an estimate for comparison with the 1991 President's request. OMB staff, in coordination with the Office of National Drug Control Policy, are in the process of refining these estimates. Therefore, small changes are probable. The goal is a set of historical drug funding tables that provide cross-cutting estimates by agency or function for all years from 1981 to 1991.

02-Feb-90

1981 Drug Control Budget Adjusted to be Comparable to 1991 President's Budget

($ in millions)

	1981	
	BA	Outlays
Department of Justice		
DEA	216.1	216.8
FBI	8.3	8.3
Criminal Div.	1.6	1.5
U.S. Attorneys	19.5	19.5
U.S. Marshals	26.3	25.0
Prisons	79.7	83.1
Support	5.9	5.4
INS	0.3	0.2
OJP	4.5	14.7
INTERPOL	0.1	0.1
Department of Treasury		
Customs	136.8	137.0
IRS	35.2	35.2
Department of Transportation		
Coast Guard	227.8	227.7
FAA	0.4	0.4
Department of State		
INM	34.7	28.4
USIA	1.0	0.5
Department of Agriculture		
Agriculture Research Service	1.4	1.4
U.S. Forest Service	0.5	0.5
Department of Interior		
U. S. Park Service	0.1	0.1
Bureau of Indian Affairs	1.7	1.7
Fish and Wildlife Service	0.1	0.1
Department of Defense	33.6	24.6
Department of HHS		
ADAMHA	239.0	233.3
IHS	1.5	1.5
FDA	1.4	1.4
Department of Education	2.9	2.9
Department of Labor	3.4	3.4
ACTION	2.5	2.5
Veterans Administration	52.0	51.8
	========	=======
FEDERAL DRUG PROGRAM (2-9-89)	1,138	1,129
Adjustment for New Accounts or Changes in Methodology	306	292
Estimated Federal Drug Budget	1,444	1,421

WRITTEN QUESTIONS FROM SENATOR ARMSTRONG TO MR. DARMAN AND THE RESPONSES

Question 1. Mr. Darman, the Administration has proposed to institute an annual tax of $100 on each mining claim held on public land. The monies derived from this tax will be used to fund the operation of the Mining Law Division of the Bureau of Land Management. This proposal will require an amendment to the 1872 Mining Law within the context of the 1991 appropriations bill. Has the Administration reversed its position concerning legislation on appropriations bills?

Answer. The proposed holding fee is not a tax. It is a user fee, paid only by beneficiaries to maintain a privilege granted by the Federal Government. The proposal substitutes a fixed cash payment for a comparable value of effort (the annual assessment work required under current law). It therefore does not place an additional compliance burden on prospectors, and is administratively simpler than the current system. Also, about 20 percent of the anticipated receipts wil be used to fund BLM's administration of the Mining Law; the remainder wil be deposited in the General Fund of the Treasury. While it is true that the Administration generally opposes the enactment of substantive legislation through the appropriations process, we annually face—and accept—dozens of such proposals that Congress has itself decided to enact in this manner. In this case, the proposal does not significantly restructure the Mining Law of 1872 and enactment in the appropriations process is the most expeditious route to take in this instance. Consequently, the Administration supports this approach.

Question 2. Mr. Darman, this new mining tax will take monies from individuals who previously used them for mineral exploration (in the form of annual assessment work) and pour them into the Federal bureaucracy. Could you explain how this budget proposal fits into an economic philosophy which promotes the free enterprise system?

Answer. The proposed holding user fee, which would be paid by holder of mining claims, is in fact more market-based than the existing annual assessment requirement. Instead of requiring on-the-ground actions whether or not the market favors them, the use of an annual holding fee leaves development decisions up to the claimant, who can then respond to market concerns rather than a government-imposed timetable. Also, instead of allowing those who have no serious intent to mine to hold claims, the holding fee will provide them with an incentive to drop their claims. This will open up lands for claim by serious entrepreneurs, who will not be deterred by the relatively modest fee level but instead base investment decisions on their expectation of returns from mining operations. Thus, the proposal strongly facilitates free enterprise.

Question 3. At a time when the mining industry continues to suffer from the effects of world-wide competition often subsidized by their governments with little or no environmental protection, shouldn't the emphasis of our proposals be to assist this important industry rather than burdening it with new taxes?

Answer. Our best hope for maintaining a viable mining industry is to promote a free-market system. To do so, we must encourage competition and serious investment; the proposed holding fee has this effect and will support the efforts of serious prospectors who are committed to exploration under the law.

U.S. FOREST SERVICE BELOW COST TIMBER SALES TEST

GENERAL

Question 1. In addition to some timber sales, what other Forest Service programs are operated below costs?

Answer. Timber sales nationally are not below cost. Overall receipts are greater than costs. However, the above cost sales are highly targeted to the Pacific Northwest and Northern California areas. Nationwide, some activities such as soil and water and wildlife do not generate receipts of any kind. Others such as recreation or range grazing do generate receipts, but fees have been held very low relative to the increasing demand which, in turn, increases cost.

LOGGING VALUES

Question 2. Logging is done for a number of reasons, such as—to name a few—forest fire prevention and control, disease prevention and abatement. What are additional reasons for logging?

Answer. Logging is an important and often cost effective means to manage forest vegetation. The management of forest vegetation has a vitally important role in the overall management of the National Forests. This includes enhancement of wildlife habitats and diversity, reducing the risk of wildlife and insect and disease epidemics, increasing water yields and improving the timing of water flows in the arid west. Timber management activities are also often a cost effective means to provide road access for recreation, fire control, and other management and administrative.

Question 3. Are values such as these taken into consideration when planning sale?

Answer. Yes. Timber sales are located and designed to achieve non-timber multiple use benefits, in addition to timber production. Sale locations and designs are modified substantially to both mitigate impacts on non-timber resources, as well as to enhance and improve these uses and values where feasible. An example is improving wildlife habitat and diversity. Roads built initially for access to timber sales are located and designed to provide access for a variety of purposes, such as outdoor recreation.

Question 4. Were such values included in the figuring of "bellow cost"?

Answer. The cost of protecting and enhancing such values are included as a timber cost in defining a below cost sale.

Below cost sales, as defined in this test, are those that are expected to return revenues that are less than the previous three-year average total timber sale program operation expenses (in the TSPIRS Statement of Revenues and Expenses for the National Park Service).

Question 5. Are anticipated costs of appeals and litigation about timber sales included in "below cost" consideration resulting in eliminating logging in three Colorado National Forests?

Answer. The cost incurred to process timber sale related appeals and litigation during the last three years is included as a timber cost for the purposes of calculating below cost sales.

Question 6. Colorado, as many other western states, is experiencing some very dry weather. Drought and dangerous fire conditions may again occur. Were the extensive costs of firefighting and the loss of recreation considered?

Answer. Not directly. However, test Forest may sell sales, even if they are below cost sales to qualify, a determination must be made that not harvesting the timber would pose an insect, disease, or a fire hazard to adjacent National Forest or private land values, and harvest is justified based upon the values that would be protected, the risks involved, and the economic losses that would be incurred in selling the sale.

Question 7. Senator Simpson mentioned in his minority views to the clean air act amendments, Section 1630, the tremendous amount of toxic air pollutants emitted from a large western forest fire. He noted the Yellowstone Park fire contained tremendous quantities of the potent carcinogen benzo-a-pyrene, exposing the western public and all those brave men and women who combatted the fires to this toxin. Did the OMB/Forest Service address the clean air and human health issues in its decision to eliminate logging in these forests—particularly in these dry times.

Answer. Timber harvesting needed to properly manage the forests are not precluded in below cost sale areas selected for this pilot project. Sales for health and safety, and protection from fire, insects, and disease will continue when determined appropriate by the Forest Service. Providing appropriate protection to the resource is standard procedure on National Forest System lands. Management "tools" available to the Forest Service include timber harvesting, maintenance of fuel breaks, and other vegetative management techniques. This is in contrast to National Park Service lands, such as Yellowstone, where active vegetative manipulation is precluded, allowing natural processes to occur.

LOGGING AS A LAND MANAGEMENT TOOL

Question 8. According to the Forest service, isn't logging one of the, if not the most valuable, land management tool available to the Forest Service?

Answer. Yes. Logging is an effective means to manage forest vegetation. See answer to Question 1 under "Logging Values."

Question 9. Isn't this test elimination of "below cost" sales likely step toward permanent elimination—for all practical purposes—of one of your most valuable management tools?

Answer. No. The proposal is only a test. Future decisions regarding the Forest Service timber program will be considered using the results for the test. Furthermore, logging is not eliminated on the Three Colorado forests. Instead, only that portion of the current program that is "below cost" and is not designed to achieve other resource objectives is eliminated during the test.

Question 10. Is it possible to change a "below cost" sale to a sale that could break even or send money to the U.S. Treasury by changing sale preparation or cutting methods, e.g., instead of physically marketing trees, cutting trees only a certain diameter at chest height (DBH)?

Answer. Yes, improving the efficiency of the timber program itself is another way of reducing the number of below cost sales. This can be done by reducing program costs and/or enhancing revenues.

TEST CRITERIA

Question 11. On whose initiative are certain timber sales being eliminated?

Answer. The below-cost timber sale proposal was developed as part of the overall FY 1991 budget process.

Question 12. OMB selected three Colorado National Forests. What was the rationale for selecting these three Colorado National Forests?

Answer. The Forest which are the subject of this test to evaluate the impacts of eliminating below-cost sales were initially selected based on the following conditions: (1) proximity to population centers, (2) demand for recreation, and (3) ability to support economic activities other than logging. The three Colorado Forests selected met all three of these criteria.

Question 13. How will these "test elimination" affect timber dependent communities, for example, Walden and Kremmling, Colorado?

Answer. There will be no effect on the "timber-dependent" community of Walden, Colordao since a very minor amout of the stumpage provided to the mill in Walden is supplied by the Test Forests. Kremmling, Colorado is not a "timber-dependent community"; however, the mill located at Kremmling is dependent upon stumpage supplied by the Test Forest (Arapaho and Roosevelt and White River NFs). There should be no effect at Kremmling in the near term since existing contracts will continue to be honored. In the mean time, an additional $10 million is being requested to enhance recreation uses. Such funding is intended to provide a shift and increase the job opportunities outside of timber.

Question 14. How much Federal Income tax revenue will be lost?

Answer. Federal income tax revenue will increase not decrease. Assuming that 15 percent of total income lost and gained through reductions in timber stumpage supplied and through increases in recreation activity, respectively, the following total Federal tax effects may be experienced for the three Test Forests.

First Year: A net increase of approximately $644,000 in Federal income taxes will occur. this is a result of increases in recreation activity with minor decreases in timber volume harvested due to existing volumes under contract. These volumes will be harvested during the early years of the Test thereby maintaining employment and income levels until the third of the five year period of the the Test.

Fifth Year: A net increase of approximately $5,291,000 in Federal income taxes will occur assuming legislation is not forthcoming. With legislation the net increase will be approximately $5,411,000 for the three test Forest.

Question 15. How much shared logging revenue will be lost to Colorado and its local communities.

Answer. "Shared logging revenue" or "payment to states" will decrease approximately $75,000 in year one of the test and approximately $331,000 by year 5.

Question 16. How much Colorado State income tax revenue will be lost?

Answer. State income taxes will significantly increase not decrease. Assuming that 5 percent of total income lost and gained through reductions in timber stumpage supplied and increases in recreation activity, respectively, the following total state tax effects may be experienced for the three Test Forests.

First Year: A net increase of approximately $214,000 in State income tax will occur.

Fifth Year: A net increase of approximately $1,764,000 in State income taxes will occur assuming legislation is not forthcoming. With legislation the net increase will be approximately $1,804,000 for the three Test Forests.

FUTURE LOGGING

Question 17. With logging stopped, won't the logging operations and mills likely vanish from these areas?

Answer. Is it not the intent of the Forest Service the logging will be stopped during the test period. Forests have two to three years of volume under contract and the following sales will be offered: (1) above costs timber sales; (2) sales with lower than average costs when revenues can be anticipated to exceed these costs; (3) sales in the "pipeline" where sale receipts are expected to equal or exceed the additional Forest Service investments on the sale that would be incurred in FY 1991 and beyond; and (4) sales for health and safety (conditional; conditions have been published).

Question 18. In the case logging operations and mills will vanish, won't it be difficult to resume logging in some of these forests wildlife or forest health or fire protection reasons?

Answer. Yes, however, it is already hard to do logging for these purposes on these Colorado forests. Due to the current lack of mill capacity, more than 70 percent of the timber volume offered in the last four calendar quarters went unsold on the Pike/San Isabel National Forest.

Question 19. Since in Colorado, numerous small logging operations and mill-dependent communities' economies will evaporate, and logging as we know it today will disappear, isn't this "test" the beginning of a very permanent change?

Answer. A key feature of the test is to expand recreation programs to determine if the impact on employment and income of a reduced sale program can be offset. A request of $10 million is included to accelerate and enhance the shift, increasing the recreation available to meet the higher demand.

Only one community, Walden, is known to be "mill-dependent." If successful, the test is so structured that economies will greatly improve, not evaporate. Communities will simply change to become less dependent upon logging and milling and more responsive to the increasing demand for other uses of the National Forest. Increased recreation will in part shift the basis of the economy of the communities that, if successful, will make them better off. Logging has dramatically declined in the three Colorado test Forests in the past years. Logging, today is not the same as ten years ago. With or without the test, it is likely that "logging as we know it today" will continue to decrease. The Region/Forest Service is active in assisting local communities in their attempts to diversify their economies and adjust in a positive manner. Change appears inevitable and the test will be a catalyst to some change.

FOREST PLANS

Question 20. Congress requires an extensive forest planning process for each forest. By eliminating logging in three Colorado Forests, OMB is preventing the Forest Service from using one of its most valuable land management tools. Multiple use is the concept governing these public lands. Isn't permanent change to forest management developed by OMB in this manner circumventing congressional intent of the statutory forest planning process and multiple use?

Answer. Logging is not eliminated on the three Colorado forests. Instead, only that portion of the current program that is "below cost" is eliminated. Other objectives such as non-timber resource objectives (i.e., wildlife) and sales for health and safety and from fire protection from fire, insects, and disease will also continue to be met. On the three Forests, the decrease in timber harvest will be respectively: Arapaho/Roosevelt, 85 percent; Pike/San Isabel, 61 percent; and White River, 58 percent. Normal timber funding for sales preparation will be supplemented by recreation and wildlife funds. For the FY 1991 test that money has been set aside, but for future years funds would have to continue to be provided through appropriations process.

Question 21. Isn't the Forest Service required to present a thorough forest plan for operation of each forest to the public for review?

Answer. Yes. If test results identify viable multiple use management options, then these options can be addressed in the Forest Plan amendments or revisions.

Question 22. Are those plans to reflect Forest Service professionals' best decisions regarding land management balanced with public demands for multiple use?

Answer. Forest Service professionals' best decisions include concerns for multiple use which come from both within the agency and from public demands.

Question 23. Aren't values such as wildlife habitat, disease control, and enhanced recreation considered in current forests plans and sales?

Answer. Yes.

Question 24. Aren't timber sales included in forest plans often subject to extensive appeals and litigation, despite land management reasons Forest Service professionals put forth for logging?

Answer. Yes.

Question 25. In addition to the appeals process, won't this proposed elimination of "below cost" sales make logging as a valuable and management tool even more difficult to be used?

Answer. No, if logging is a valuable land management tool that is needed to reach Forest objectives, then it would be selected. See the answer to question 20 for further details.

REVENUE FROM LOGGING VERSUS RECREATION

Question 26. To offset lost logging revenue in these forests, are you considering fee increases or new fees?

Answer. Both, however, most of the anticipated increase in recreation receipts would be expected from new fees collected at sites and for uses previously not charged for. A smaller portion of the increase would come from increasing existing fees where facilities had been expanded or improved. All receipts, except the 25 percent share to states, would be available for further enhancement of recreation facilities on the test forests.

Question 27. If so, on what activities?

Answer. The Forest Service proposes to test various combinations of the following recreation fees:

(1) Increased fees existing fee sites based on investment to provide additional amenities.

(2) Recreation use fees for campgrounds which do not presently meet the minimum requirements prescribed by legislative authority.

(3) Recreation use fees for additional facilities such as picnic areas, boat ramps, swim sites, visitor information sites and parking lots.

(4) Entrance fees at developed recreation complexes.

(5) Wilderness entrance permits.

(6) Recreation permits to float certain high use rivers.

(7) Arapaho National Recreation Area entrance fee.

(8) A general recreation use fee through a motorized parking permit.

We would not implement all these fees on one individual national Forest. Rather, each Forest will (with public involvement) select the best combination of fees to meet the unique characteristics of the test National Forests. Those National Forests charging a motorized vehicle parking permit would not also charge other fees except at developed recreation sites.

LOGGING

Question 28. Aren't the number of logging and recreation jobs generated logging and recreation income comparable in these three Colorado National Forests, according to the Forests Service?

Answer. The present number of recreation jobs are far greater than the timber jobs on the three proposed Colorado test Forests.

The recreation related income also far exceeds the timber income. The ski industry with the ski slopes primarily on National Forests, and their associated four season resorts are the primary reason for the large differences.

ESTIMATES OF EMPLOYMENT AND INCOME EFFECTS FOR COLORADO

	1991 current	Without test fee legislation		With test fee legislation		LMP
		1st	5th	1st	5th	
Arapaho and Roosevelt:						
Timber related jobs	171	171	24	171	24	317
Recreation jobs	8,063	8,173	8,426	8,173	8,443	8,958
Timber income (thousands)	$3,552	$3,522	$633	$3,522	$633	$6,609
Recreation income (thousands)	$167,810	$170,252	$175,834	$170,252	$176,214	$187,176
Pike and San Isabel:						
Timber related jobs	220	220	11	220	11	499
Recreation jobs	6,743	6,806	6,801	6,806	6,809	10,792
Timber income (thousands)	$4,671	$4,671	$292	$4,671	$292	$10,600
Recreation income (thousands)	$129,343	$130,653	$130,536	$130,653	$130,710	$206,241
White River:						
Timber related jobs	145	138	16	138	16	355
Recreation jobs	23,247	28,280	26,267	23,280	26,267	29,337
Timber income (thousands)	$2,986	$2,833	$500	$2,833	$500	$7,058
Recreation income (thousands)	$442,924	$443,615	$500,779	$443,615	$500,779	$559,898

ESTIMATES OF EMPLOYMENT AND INCOME EFFECTS FOR COLORADO—Continued

	1991 current	Without test fee legislation		With test fee legislation		LMP
		1st	5th	1st	5th	
Total Colorado:						
Timber related jobs	536	529	51	529	51	1,171
Recreation jobs	38,053	38,259	41,494	38,259	41,519	49,087
Timber income (thousands)	$11,179	$11,026	$1,425	$11,026	$1,425	$24,267
Recreation income (thousands)	$740,077	$744,520	$807,149	$744,520	$807,703	$953,315

Note.—Employment and income effects based on timber volumes estimated to be harvested rather than offered. These volumes are currently under contract and will be harvested regardless of the BCTI.

COLORADO FOREST HEALTH

Question 29. Do older trees in Colorado exhibit different characteristics from aging trees of the Pacific Northwest, for example, fire resistance or disease resistance?

Answer. No known difference is recognized. Aging characteristics are more dependent on species than on the location. The site productivity also effects the aging characteristics; because the average site productivity is much poorer in Colorado than in much of the Pacific northwest, trees of the same species may demonstrate less resistance to disease or insects in Colorado than in Pacific Northwest. However, it is unlikely that there would be a variance if both species and site productivity were identical. Fire resistance is primarily dependent on species and weather conditions. Trees of the same species frequently mature at a much small size in Colorado than in the Pacific Northwest; this is due to site productivity and probably the genetic base.

Question 30. Aren't the majority of Colorado's forests approaching the older end of the spectrum?

Answer. Because it is difficult to come to an understanding of what is meant by "the spectrum" the following chart provides a breakdown of age classes by percent of acreage for all Colorado Forests:

Age	*Percent of acreage*
<81 years	11
81–120 years	26
121–180 years	41
>180 years	22

It is true that approximately 50 percent of the timbered acres have trees that are producing on net saw timber growth (mortality or increase in defect equals or exceeds growth). Most species of trees found in Colorado are highly susceptible to disease and insects once they reach 80 years of age and rapidly become increasingly susceptible to disease. Lodgepole pine becomes increasingly susceptible to mountain pine beetle attack it reaches about 120 years of age.

VIEWS OF THE SECRETARY OF THE TREASURY AND COUNCIL OF ECONOMIC ADVISERS

THURSDAY, FEBRUARY 1, 1990

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:40 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser, (chairman of the committee) presiding.

Present: Senators Sasser, Riegle, Exon, Sanford, Wirth, Fowler, Conrad, Robb, Domenici, and Bond.

Staff present: John Hilley, staff director; and Charles Marr, economist.

For the minority: G. William Hoagland, staff director; and Cheryl Reidy, economist.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman Sasser. The committee will come to order, and I want to welcome this morning the distinguished Secretary of the Treasury, Mr. Nicholas Brady, and the Chairman of the Council of Economic Advisers, Dr. Michael Boskin, to the Senate Budget Committee this morning.

Let me begin by saying, Mr. Secretary and Dr. Boskin, that we have seen a lot of turbulence in recent days, and certainly I suppose this contention surrounding the budget is going to continue as we try to thrash it out in the weeks ahead. But I do believe that in the final analysis there is a common ground in spirit and intent. And I think all of us in this room would agree that at its core the budget for fiscal year 1991 should be a plan that renews our domestic economy while at the same time restores our global competitiveness.

Now this new global era that we are in, I think, presents remarkable opportunities for domestic economic renewal. But there is a real problem facing us. In my view it is an unstated problem that is at the root of much of the controversy about the Federal deficit. We find that as we have freed ourselves from the stagnation of the cold war, we may have handcuffed ourselves by our dependence on foreign capital. And find ourselves hampered by a weakened position in the world economy. I think a case can be made that the volatility of our stock markets in recent weeks illustrates the degree to which this country is beholden to the decisions of foreign investors and policymakers perhaps to a degree unprecedented since before the First World War.

Although it staged a recovery yesterday, the market has been falling, on speculation that the Japanese plan to scale back their investment here to take advantage of the rising interest rates in Japan. They are alarmed in Japan about a runaway inflation rate of 2.5 percent. So they are raising their rates there, and now the Japanese are keeping some of their money at home and even siphoning it off to West Germany perhaps in anticipation in investments in the developing Eastern European markets.

But foreign investors in weeks and months and years past have been eager subsidizers of our deficit. They have been currently buying 30–40 percent of our Treasury bonds in recent years, and as a result interest rates in America are subject to judgments made in Tokyo about what is good for Japan some economists are saying. Now I see that as a threat not only to our decisionmaking process, but also to our autonomy and independence and perhaps ultimately to the quality of life of this nation.

It is against this backdrop, I think, that any budget proposal, any plan for domestic renewal, is going to have to be considered. I think there is agreement all around that we have got to drag ourselves out of this swamp of deficits. We agree that we must free up our resources to invest in the neglected domestic economic needs of this nation, and to do that I think we also all agree that we have got to get our national savings rate up, and we have got to get more real growth in our economy.

But that is where the common road seems to diverge. The President's proposals to cure the savings and investment shortfall in this country are certainly well intended, but in my judgment I think they miss the mark. I think we understand here or we should understand that there are two parts of national savings. One is private savings and one is government savings. The administration's family savings plan works in the field of private savings, but it appears to take back with one hand what it gives with the other. It provokes a minimal increase in private savings, but it also loses revenue along the way. This raises the deficit and drains the overall national savings pool. Moreover, it is very hard to encourage working Americans to save when they are burdened with a tax structure that weighs more heavily on working middle class Americans than on the wealthier segment of our population who already have the resources to save.

Right now fully 70 percent of the American people pay more in regressive payroll taxes than they do in the progressive income tax. I saw figures the other day, and they were publicized very widely in a national publication of some distinction that a family of four with a $30,000 income pays 10.7 percent of their income in payroll taxes. The same family with an income of $150,000 pays only 5.5 percent of their income in payroll taxes.

At the start of the 1980 payroll taxes comprised 30 percent of Federal revenues. Today 10 years later they comprise 36 percent of all Federal revenues. So the squeeze on middle income families has never been more apparent, and perhaps that is why, as I indicated yesterday, the waitresses in Knoxville, TN find the idea of a payroll tax cut very, very attractive indeed, and have communicated it to this senator.

Now that brings me to the other major component of the administration's savings and investment plan, and that is the much discussed capital gains provision. In my view, a cut in the capital gains tax does nothing to alleviate the squeeze on working Americans that I have just discussed. According to the numbers that I have seen, 80 percent of the benefits of such a cut are going to flow to the wealthiest 1 percent of our citizens. Rather than tapping the enormous savings potential of the broad base of Americans, capital gains legislation, it seems to me, merely rewards the highest income group for doing what they were going to do anyway even without a capital gains tax cut.

As much as we would like the initial rush of revenues from a capital gains tax cut and certainly we would like that here on the Budget Committee, it is hard for me to see how that is going to spur economic growth. I think what we need to do is create new savings, not to reward the reshuffling of old portfolios. Not all the differences that I have with the President's budget are over such explicitly stated policy matters. I am also concerned about what this budget assumes. I am concerned about what it leaves unsaid. In particular, and Dr. Boskin will have an opportunity to address this this morning, interest rate assumptions in the budget seem to contradict everything the economy is telling us at this particular moment.

A conspicuous silence on the continued financing of the savings and loan bailout seems to emanate from the President's budget. But I have confidence that both of our guests here today, who are experts on these issues, can fill the voids for us, and I will look forward to their testimony. We are pleased to be joined by the distinguished ranking member of the committee this morning, Senator Domenici, and I would now like to turn to him for any remarks and observations he might wish to make. Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator Domenici. Thank you very much, Mr. Chairman. Might I say to you and to the two witnesses I apologize for being a bit late this morning, but I assume we are going to have ample time to hear from the witnesses and to express our views. Obviously this is another new year, and we welcome both of you here. I am looking forward to hearing your views on the budget and the economy.

We were presented with the President's budget on Monday. Some do not view the budget plan as real; I do. I do not agree with all of the President's priorities, and I will work to change some of them. But I believe his budget plan as put forward represents real savings and offers real prospects for deficit reduction. This budget projects that, with steady growth and moderate interest rates, budget deficits will come down. I agree with the Federal Reserve Board Chairman, Alan Greenspan. He has said repeatedly that what is important to the financial markets is real action on our part that causes investors to have a reasonable expectation that deficits will be dramatically lower in the future.

I would like to focus just for a moment on a topic that is on virtually every economist's and national leader's short list of crucial issues, and the chairman has raised it: the issue of national savings. Both of our witnesses today agree with that concern, and I am sure that it is high on your priority list, and I am sure that you agree that the pool of savings must be increased. With more savings, interest rates have the best chance of falling, and investment will rise. The United States will borrow less from foreign investors to finance growth.

One way obviously to increase savings is to reduce the budget deficit, and we are here trying to work on that problem. This administration has also proposed the family savings account as another way to spur savings, and I understand this costs the Treasury little money because the interest earned on a family savings account would be tax-free as long as it was kept in the account for 7 years.

Dr. Boskin, you have said that you are sure that the savings plan will increase national savings by an amount that is greater than the cost to the Treasury. I hope you are right, and I think you ought to talk with us about what distinguishes it from some of the other programs such as IRA's and the like. I believe you have said before that IRA's while reasonably good, were not exactly as they appeared in that much of the savings were mere transfers from what would otherwise be saved.

I would like to share something with you that I think is the fundamental problem. Last year, the Public Agenda Foundation conducted a pilot study on public attitudes toward saving, investment and competitiveness. The results were truly eye-opening. An alarming gap exists between what leaders and the public understand as to the cause of this country's declining competitiveness. Many Americans question both the virtue and the utility of savings.

The survey was startling to me. I am sure you, Dr. Boskin, knew it all along. But most Americans either dismiss or simply do not understand the notion that industry in the United States in its broadest sense needs savings to provide the capital so they can invest in modernization and new products and services. Listen to this. When Americans were asked by this survey group whether savings was a good thing or a bad thing for the economy, most, an overwhelming percentage of Americans, said savings hurts the economy more than it helps it. Folks out there seem to echo the theory that saving money will cause consumers to spend less, and they assume that spending more is the very best thing for the economy.

They feel that the money saved is somehow taken out of circulation. Conversely, money spent is circulated through the economy and creates jobs. People were strongly skeptical of the claim that there is a connection between how much people save and how much is available to business for investment. The attitude was, and on this one I quote, "let the companies worry about their own problems." Now that was actually the statement in the survey. I note with a great deal of interest that if one tries to distinguish between what is happening in Japan and what is happening in America, you need to look at the public's attitudes toward business problems. The Japanese have a different attitude, and that may be one of the core differences between the two countries. With these attitudes in mind, we have to think hard about whether public policy alone will increase private savings.

It appears we also have another job to do, and that is to some way or another change attitudes about the need to save. Frankly, I have just about given up on that. I do not think there is any leader under any circumstance that can convince the American people they really ought to save. I do not know if anybody has figured out any way to do that. That is why we are inventing incentives of one type or another. But I do hope the President's plan works.

Now let me comment on the social security issue, and I hope you will comment on capital gains. Frankly, I think the President in a very simple way that everyone will understand said it right last night: let's not mess around with social security. And I believe before too many more weeks pass that is what the American people are going to say. They are not going to believe that they are more apt to get their benefits now and in the future if we collect less in revenues for social security. I just do not think they are going to believe it.

I would like to just comment briefly on that issue as it concerns the public debt because our efforts to reduce the deficit have to be directed at trying to reduce the public debt. Obviously we should not stop working on fiscal policy when the budget is balanced because we have a $3-plus trillion public debt. That is a draw on private savings. If we can get the national budget to balance under Gramm-Rudman-Hollings, and literally thereafter keep it at zero while we make up for those social security reserves that are being counted, probably there is no plan around that is more apt to increase national savings than the plan conceived by the 1983 Social Security Blue Ribbon Commission. They had exactly in mind that the surplus in the Social Security Trust Fund will buy down the national debt and thus reduce the debt by huge amounts.

Now I cannot conceive of any better plan. Everyone is talking about savings. If we do it right, the most significant opportunity in modern times to accumulate savings is to leave social security alone and get the current operating deficit under control as soon as possible. Then we will see the most dramatic accumulation of savings that this country has ever seen. I think it is inconsistent to talk about reducing social security taxes because of the way it is treated in the Gramm-Rudman-Hollings accounting system, and at the same time to express genuine concern about national savings.

It appears to me we have the best plan around, and we ought to go ahead and do it. The sooner we get the current debt under control, the sooner the drag of the accumulated national debt begins to disappear. I do not know how we will ever do a better job of ridding the private sector of the obligation to buy the national debt. If we are worried about foreign ownership of our debt, we have a ready-made 10-year program to get rid of any need for their money at all because by about 2005 there will be no public debt. And so foreigners will not have to invest in it.

My last comment is for those who are so fearful of Japanese investments here. I would like you, if you could today, give me some information. If you do not, I would like you to get it for me. We wonder how much others are investing here in the U.S. with some trepidation. I think we ought to get on the record how much American companies invest overseas. I think the ratio is very skewed our way. I think the Japanese might be investing $35 billion on the one hand in businesses and the like, and I think American companies are investing $700 billion overseas. But I would like you to confirm those numbers or tell me what they are for this record. I think they are somewhere in that ball park. Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici. We will turn now to Secretary Brady for his testimony and then Dr. Boskin, and if you wish, Mr. Secretary, please feel free to summarize your testimony this morning.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman. I have some foreshortened remarks, and I would ask that the rest of my remarks be incorporated by reference, and I would just say one thing before I start in response to Senator Domenici's question. We certainly will give him the figures he wants, but I agree with him. Before we spend too much time worrying about the Japanese, it should be recognized that the British investment in the United States is roughly double that what the Japanese is. So that statistic may be of interest.

I am pleased to meet with you to discuss the Bush administration's fiscal policy plans. These hearings provide a useful opportunity to analyze our budget spending and revenue strategies. Director Darman has presented a comprehensive overview of the budget proposal and Chairman Boskin will analyze the underlying economic conditions and prospects. My comments will concentrate on the economic policy consequences of the budget and recommendations for revenue initiatives.

Three points should be emphasized. First, significant progress has been made in reducing the unacceptable level of budget deficits. Second, we still have a long way to go. Third, intensified effort is required to meet the challenges created by changing economic conditions and national priorities. The Bush administration believes that our budget goals can be achieved without increasing tax burdens on the American people. A pledge to submit a budget proposal that meets the statutory targets without increasing taxes has been met again this year. The budget deficit has declined from $221 billion in 1986 to $152 billion in fiscal year 1989. It is expected to fall to $123 billion during the current fiscal year and to a target of $63 billion in fiscal year 1991.

Government spending has been restrained while revenues have increased. Federal outlays as a percent of the gross national product are expected to decline from the peak of 24 percent in fiscal year 1983 to a proposed 21 percent level in fiscal year 1991. Budget revenues have increased during the current cyclical expansion and are estimated to total 19.9 percent of the GNP in fiscal year 1991, a figure well above the average of 18 percent during the 1950 to 1979 period. Spending restraint has reduced the growth rate of Federal budget outlays.

Expressed in nominal terms the pace of annual spending increases was cut nearly in half in the fiscal years 1983 through 1989. Further deceleration for the years through 1995 is projected in the new budget. Adjusting for the effects of inflation reduces the pace of a slowdown, but the pattern is similar. The combination of spending restraint and improving revenues has narrowed the size of the budget deficit as a share of GNP from 6 percent in 1983 to just under 3 percent last year.

Chairman SASSER. I thought we heard 1 percent last night, Mr. Secretary?

Secretary BRADY. No, this is for last year.

Chairman SASSER. Oh, OK.

Secretary BRADY. Further progress to 2.3 in fiscal year 1990 and 1.1 percent in fiscal year 1991 is anticipated. The reduction of the annual budget deficit combined with continued economic growth has reversed the upward trend in the national debt held by the public as a proportion of the GNP. There are charts at the back of my testimony to show graphically these figures over a period of time. If we continue to reduce prospective budget deficits and achieve the lower rate targets, the rising trend of interest payments on the national debt as a share of total budget outlays will be reversed.

Progress in controlling budget deficits has improved the U.S. record in comparison with other major industrial nations. This effort is part of our commitment to the G–7 international coordination process of domestic policies, a part of the progress in reducing Federal budget deficits as a result of the growing size of annual surpluses in the Social Security Trust Fund. A surplus results when current benefits paid are less than payroll tax contributions collected, interest earned on the government bonds held by the trust fund, and taxes levied on social security benefits. The size of the annual surplus has grown from $262 million in 1984 to $52.4 billion in 1989. The estimated surplus in fiscal year 1990 is $62 billion, and for fiscal year 1991 it is $80 billion.

The annual surpluses are expected to continue to grow rapidly until the baby boom generation begins to retire early in the next century. The impact of social security surpluses on the deficit follows from the use of unified budget rules. These rules were adopted in 1968 based on the recommendations of a national commission appointed to study the Federal deficit. The unified budget was designed to measure the broad economic impact of Federal outlays and revenues. These rules were in place in 1983 when the Social Security Trust Fund decisions were made. They were used again in 1985 when Gramm-Rudman-Hollings budget deficit goals were established, and they were understood in 1987 when the original Gramm-Rudman-Hollings targets were revised.

The targets adopted were based on unified budget concepts. Measured against the targets established, progress toward the mandated goals has occurred. Our fiscal 1991 budget sets forth in separate columns the projected deficit before and after the effects of Social Security Trust Fund surpluses, and they are considered so that the analysts can form their own opinion. The Bush administration is committed to reducing prospective budget deficits and has prepared a formal proposal to protect the Social Security Trust Fund starting in fiscal year 1993 when the required unified budget balance is achieved.

Budget plans must recognize the link between investment and the achievement of long-term national goals. Investment in new plants and equipment, new technology, and human resources through better education, training and health care depends upon a matching supply of savings. To avoid excessive reliance on foreign capital inflows to finance these crucial investment needs, national savings must be increased. Our disappointing national savings rate is a combination of personal, business, and government savings behavior.

There has been erosion in the personal savings rates in recent years and business saving has remained stable only because of higher depreciation rates. However, chronic Federal budget deficits reported in 28 of the last 29 years have become the dominant factor in the overall decline in the national savings rate. The United States now has a national savings rate than is lower than its historical average and far below that of the record of most industrial nations. The key policy action for correcting this serious problem will be to reduce Federal budget deficits in the future. Necessary improvement in the national savings rate should become the crucial test in evaluating budget outlay and revenue strategies. The administration budget for 1991 recognizes the link between long-term national priorities and the need to increase investment and national saving by emphasizing two basic policies.

First, continue to reduce the deficits to achieve a balance by 1993 by controlling budget outlays and Federal credit programs. Second, enact the Savings and Economic Growth Act of 1990 to increase family savings, stimulate job creation, increase long-term investment, and strengthen the ability of American businesses to compete in the challenging global economy. Improving the national savings rate is important because it will help to lower the cost of capital to American firms and provide the funds for investment in our future. There are three parts to this new legislation.

A new family savings account is established to give most American families the incentive to save through a simple and understandable tax-free savings program. The new family savings accounts will provide a simple and understandable program for Americans to save and see the benefits of changing their behavior. The time limit is short enough to focus attention on specific personal goals: saving to buy a home, preparing for education costs, or for building a financial reserve to protect against unexpected events or any high priority goal.

This is a program that Americans can understand and participate in without having to wait for long periods to have access to their savings. From the government's perspective, the Federal savings account does not cause large revenue losses at the beginning of the program because the contributions are not tax deductible. Instead, the earnings created by the contributions to the plans will be exempt from taxes. This approach is prudent because we can evaluate the results as we go.

Second, capital gains tax rates are reduced and restructured to lower the cost of capital, encourage long-term investment, create jobs, and enhance the Nation's competitiveness. The administration believes that a reduction in the tax rate on capital gains would have several effects. First, the capital gains tax rate is an important component of the cost of capital which, in turn, directly affects the ability of U.S. companies to compete worldwide. Our major trading partners already either have a lower capital gains tax rate or no tax on capital gains at all. By reducing capital gains, we will enhance our ability to compete. By reducing the tax rate on capital gains, we will encourage venture capital investments and all types of entrepreneurial activities. The result will be a better economy, more jobs, and most importantly, a higher standard of living for U.S. workers.

The sliding scale would provide incentives to induce people to make longer range investments. The benefits of a capital gains tax rate cut would be widely distributed throughout the population. In a typical year 14 million tax returns representing approximately 26 million taxpayers report income from the sale of capital assets. Based on 1987 data about 41 percent of net long-term capital gains were reported by taxpayers with adjusted gross income excluding capital gains or losses of under $50,000. Furthermore, it is estimated that nearly half of all taxpayers report capital gains in one year or another during their lifetime.

An innovative home ownership initiative is created to provide millions of Americans who aspire to buy their first home a better opportunity to do so. This would enhance the attractiveness of IRAs as a vehicle for savings.

While the budget provides an important guide for long-term development of the economy, the pace of economic activity is an important factor in determining the size and the shape of the budget. The U.S. economy is now in its eighth year of sustained growth, a peace time expansion which is a record.

The strong economic growth achieved during this expansion has been accompanied by low and stable inflation rate. I think I will leave the rest of my remarks on the economic assumptions in the interest of time to Chairman Boskin.

In conclusion, the realities of our domestic and international responsibilities indicate that budget plans must be made in the context of continuing fiscal restraint. After many years of simply adding new government spending programs to existing claims, we now must rearrange our existing priorities and choose between them. The fiscal year 1990 budget proposals and the 5-year planning horizon concentrate on two priorities: reduce Federal budget deficits and reallocate resources into investments in people, technology, and capital goods to prepare for the future. The proposed budget will achieve a significant reduction in the deficit of $63 billion in 1991 meeting the Gramm-Rudman target. Reaching this goal will yield major benefits.

One, it will curtail further credit demands in the financial markets leading to better access to capital and lower interest rates for consumers, home buyers, business firms, and State and local governments. It will reduce the share of total national output allocated to government, and shift resources into the private sector creating more jobs and improving our international competitiveness. It will help ease the burden of future interest payments on the accumulated national debt. Achieving these dual goals of reducing prospective budget deficits and realigning spending priorities is dependent upon sustaining economic growth that provides tax revenues and creates investment opportunities.

Our budget proposals assume moderate growth in the 2.5 percent zone in 1990 although the quarterly pattern may fluctuate and assumes that inflation remains under control. This outcome will lead to the eighth year of continuous economic expansion. A second benefit of continued budget spending, restraint and deficit reduction will be the increased flexibility to provide the Federal Reserve System a management tool in the management of monetary policy.

Finally, the most important aspect of the 1991 budget is the emphasis on long-term national goals. Economic events have demonstrated the relationship between saving and investment and the problems created by our disappointing national savings rate. The fiscal 1991 budget provides a package of incentives to enhance national savings and investment. When combined with a significant reduction of budget deficits, these recommendations will improve the national savings rate without increasing tax burdens on the American people. The Bush administration is prepared to work with Congress to enact a responsible budget for 1991. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Mr. Secretary.

[The prepared statement of Secretary Brady follows:]

Testimony of Nicholas F. Brady
Before the
Budget Committee
United States Senate
February 1, 1990

Chairman and Members of the Committee, I am pleased to meet with you to discuss the Bush Administration's fiscal policy plans. These hearings provide a useful opportunity to analyze our budget spending and revenue strategies. Director Darman of the Office of Management and Budget has presented a comprehensive overview of the budget proposals and Chairman Boskin of the Council of Economic Advisers will analyze the underlying economic conditions and prospects. My comments will concentrate on the economic policy consequences of the budget and recommendations for revenue initiatives.

Three points should be emphasized. First, significant progress has been made in reducing the unacceptable level of budget deficits. Second, we still have a long way to go to achieve our budget goals. Third, intensified effort is required to meet the challenges created by changing economic conditions and national priorities.

- The budget deficit has declined from $221.2 billion in FY 1986 to $152.0 billion in FY 1989. It is expected to fall to $123.8 billion during the current fiscal year and to a target of $63.1 billion in FY 1991. Our budget proposal fulfills the mandatory Gramm-Rudman-Hollings deficit reduction goal.

- Government spending has been restrained while revenues have increased. Federal outlays as a percent of the gross national product are expected to decline from a peak of 24.3 percent in FY 1983 to a proposed 20.9 percent level in FY 1991, a figure closer to the 19.2 percent average which existed from 1950 through 1979 (see Exhibit 1). Budget revenues have increased during the current cyclical expansion and are estimated to total 19.9 percent of the GNP in FY 1991, a figure well above the average of 18.0 percent during the 1950 to 1979 period.

- Spending restraint has reduced the growth rate of Federal budget outlays. Expressed in nominal terms, the pace of annual spending increases was cut nearly in half in the Fiscal Years 1983 through 1989 from the prior seven-year period. Further deceleration for the years through 1995 is projected in our new budget. Adjusting for the effects of inflation reduces the pace of the slowdown but the pattern is similar (See Exhibit 2).

- The combination of spending restraint and improving revenues has narrowed the size of the budget deficit as a share of the GNP from 6.3 percent in 1983 to 2.9 percent last year. Further progress to 2.3 in FY 1990 and 1.1 percent in FY 1991 is anticipated (see Exhibit 3).

- The reduction of annual budget deficits, combined with continued economic growth, has reversed the upward trend in the national debt held by the public as a proportion of the GNP (see Exhibit 4).

- If we continue to reduce prospective budget deficits and achieve the lower interest rate targets, the rising trend of interest payments on the national debt as a share of total budget outlays will be reversed (see Exhibit 5).

- Progress in controlling budget deficits has improved the U.S. record in comparison with other major industrial nations. This effort is part of our commitment to the G-7 international coordination of domestic economic policies (see Exhibit 6).

Part of the progress in reducing Federal budget deficits is the result of the growing size of annual surpluses in the Social Security Trust Fund. A surplus results when current benefits paid are less than the payroll tax contributions collected, interest earned on the government bonds held by the trust fund, and taxes levied on social security benefits. The size of the annual surplus has grown from $262 million in FY 1984 to $52.4 billion in 1989. The estimated surplus for FY 1990 is $62.0 billion and for FY 1991 it is $80.3 billion. The annual surpluses are expected to continue to grow rapidly until the baby boom generation begins to retire early in the next century.

The impact of social security surpluses on the deficit follows from the use of the unified budget rules. These rules were adopted in 1968, based on the recommendations of a national commission appointed to study the Federal budget. The unified budget was designed to measure the broad economic impact of Federal outlays and revenues. Those rules were in place in 1983 when the Social Security Trust Fund decisions were made. They were used in 1985 when the Gramm-Rudman-Hollings budget deficit goals were established. And they were well understood in 1987 when the original Gramm-Rudman-Hollings targets were revised. The targets adopted were based on the unified budget concept. Measured against the targets established, progress toward the mandated goals has occurred. Our FY 1991 budget sets forth in separate columns the projected deficit before and after the effects of the Social Security Trust Fund surpluses are considered so that analysts can form their own opinion. The Bush Administration is committed to reducing prospective budget deficits and has prepared a formal proposal to protect the Social Security Trust Fund starting in FY 1993 when the required unified budget balance is achieved.

ECONOMIC POLICY GOALS AND THE BUDGET

Budget plans are used to identify national priorities and coordinate the allocation of resources. They also are used to develop government policies to help achieve the fundamental goals of sustaining economic growth, improving our national ability to compete in an integrated world economy, and adjusting to fundamental demographic trends. Budget plans must recognize the link between investment and the achievement of national long-term goals. Investment in new plant and equipment, new technology, and human resources through better education, training, and health care depends upon a matching supply of savings. To avoid excessive reliance on foreign capital inflows to finance these crucial investment needs, national savings must be increased.

The disappointing national saving rate is a combination of personal, business, and government saving behavior. There has been erosion in the personal saving rate in recent years and business saving has remained stable only because of higher depreciation charges. However, chronic Federal budget deficits, reported in 28 of the last 29 fiscal years, have become the dominant factor in the overall decline in the national saving rate (see Exhibits 7 and 8). The United States now has a national saving rate that is lower than its historical average and far below the record of most industrial nations. The key policy action for correcting this serious problem will be to reduce future Federal budget deficits.

The necessary improvement in the national saving rate should become the crucial test in evaluating budget outlay and revenue strategies. The Bush Administration budget for FY 1991 recognizes the link between long-term national priorities and the need to increase investment and national saving by emphasizing two basic policies.

First, continue to reduce prospective budget deficits to achieve a balanced position by FY 1993 by controlling budget outlays and Federal credit programs.

Second, enact The Savings and Economic Growth Act of 1990 to increase family savings, stimulate job-creating, long-term investment, and strengthen the ability of American businesses to compete in a challenging global economy. Improving the national saving rate is important because it will help to lower the cost of capital to American firms and provide the funds for investment in our future. There are three parts to The Savings and Economic Growth Act:

- A new Family Savings Account is established to give most American families an incentive to save through a simple and understandable tax-free savings program.
- Capital gains tax rates are reduced and restructured to lower the cost of capital, encourage new long-term investment, create jobs, and enhance the Nation's economic competitiveness.
- An innovative Home Ownership Initiative is created to provide millions of Americans who aspire to buy their first home a better opportunity to do so.

Current Economic Conditions

While the budget provides an important guide for the long-term development of the economy, the pace of economic activity is an important factor in determining the size and shape of the budget. Economic conditions affect the level and composition of outlays, particularly those benefits indexed to inflation and those spending programs designed to act automatically to offset some of the cyclical shifts in activity. The status of the economy also influences the level and composition of revenues.

The U.S. economy is now in its eighth year of sustained real growth -- a record peacetime expansion -- during which output gains have averaged 4 percent annually. The strong economic growth achieved during this expansion has been accompanied by a low and stable inflation rate. The annual increase in the CPI averaged 3.7 percent from 1982 through 1989, dipping down to 1.1 percent in 1986 when oil prices fell. It never exceeded 4.6 percent in earlier years, in sharp contrast to the double-digit rates at the turn of the decade. Excluding the more volatile food and energy components, inflation has held in the 4 to 5 percent range throughout most of the expansion. The reduction and stabilization of inflation rates have helped to reduce interest rates from the unusually high levels at the beginning of the 1980s.

Perhaps the most impressive aspect of the sustained growth of the U.S. economy has been the creation of nearly 21 million jobs since the beginning of the current expansion. New jobs have been created in the services industries, such as transportation, public utilities, wholesale and retail trade, government functions, and diverse health, education, and financial activities. Employment has increased in the manufacturing and construction sectors as well. As a result, the civilian unemployment rate has fallen from a peak of 10.8 percent in November 1982 to the 5.3 percent level that persisted during the last half of 1989. Figures compiled by the Organization for Economic Cooperation and Development (OECD) covering the period 1965 to 1988 dramatize the rapid growth of new jobs in the United States.

Employment Increases 1965-1988
(in millions)

	United States	Japan	OECD Europe
1965-1988	41.9	12.8	10.0
1975-1988	27.4	7.9	5.9

Economic growth also has been solid and sustained in the international economy as well, both reflecting and contributing to the long upswing in the United States. Growth in the OECD industrial economies should be about 3 percent in real terms in 1990, the eighth consecutive expansion year, and inflation pressures are well contained. Prospects also are good for strengthened growth in the developing countries, especially as the outlook for the large debtor nations improves.

This favorable outlook partly reflects the intensified economic policy coordination process among the major industrial nations. Exchange rates are now more consistent with economic fundamentals than they were several years ago. The U.S. dollar has been relatively stable since 1987, especially when compared with the sharp appreciation of value from July 1980 through February 1985 and the subsequent rundown through 1987. Growing world trade flows, due in part to bilateral and multilateral U.S. efforts to promote an open trade and investment system, have supported the expansion. And a much higher level of confidence about the future has led to an increase in investment in industrialized countries. U.S. producers in particular have benefited from improved international competitiveness, as well as expanded export opportunities resulting from stronger growth abroad. As a result, the U.S. merchandise trade deficit has been reduced from a record $152 billion in 1987 to an estimated $110 billion last year, and important progress has been made in regaining lost market shares (Census basis).

In summary, the seven-year economic expansion in the United States has provided sustained growth, a stable inflation rate, creation of nearly 21 million jobs and lower unemployment rates, improved balance among major sectors and geographical areas, and, since 1987, a more stable U.S. dollar foreign exchange rate and improvement in the merchandise trade and current account deficits.

Mid-Session Budget Review Economic Forecast

Last July, the Bush Administration published its first economic forecast as part of the Mid-Session Budget Review. Administration economists adjusted the previous forecast, published in the FY 1990 budget last January, by reducing the projected rate of real economic growth and raising the anticipated inflation rate and interest rate estimates for 1989 and 1990.

RECORD OF ADMINISTRATION MID-SESSION FORECAST

	ADMINISTRATION FORECAST	ACTUAL
	(PERCENT)	
Real GNP (4th Q to 4th Q)	2.7	2.4 (1)
GNP Price Deflator (4th Q to 4th Q)	4.2	3.8 (1)
Total Unemployment Rate (Yr. Avg.)	5.2	5.2
3-Month T-Bill Rates (Yr. Avg.)	8.0	8.1
10-Year T-Notes (Yr. Avg.)	8.5	8.5

(1)Department of Commerce Estimates, 1/26/90.

According to the preliminary estimates released on January 26, 1990, real GNP increased 2.4 percent in 1989, a pace very close to the Bush Administration figures published last July and above the more pessimistic projections of most comparable economic forecasts. There was, however, considerable deceleration of activity during the last three months of the year and a worrisome acceleration of food and energy prices at year-end. These developments will have to be watched closely.

Economic Assumptions Used in Preparing the FY 1991 Budget

The Bush Administration's new forecast continues to anticipate moderate growth this year, followed by some acceleration in 1991, and then a return to the long-term growth track of 3.0 percent. Most private forecasts agree that an economic recession will not occur in 1990 even though there is some disagreement about the probable growth rate of real output. Most of the Administration's economic assumptions are quite similar to the expectations of private forecasters.

ADMINISTRATION FORECAST FOR 1990 COMPARED WITH BLUE CHIP CONSENSUS
(PERCENT)

	Administration January 1990	Blue Chip January 1990
	(Percent)	
Real GNP (4th Q to 4th Q)	2.6	1.8
GNP Price Deflator (4th Q to 4th Q)	4.2	4.0
Consumer Price Index (4th Q to 4th Q)	4.1	4.2
Unemployment Rate, Civilian (Yr. Avg.)	5.5	5.6
3-Month T-Bills (1) (Yr. Avg.)	6.7	7.1
10-Year T-Notes (1) (Yr. Avg.)	7.7	N/A

(1) Calendar year average.

THE FY 1991 BUDGET SPENDING PLANS

The President's FY 1991 budget continues to make progress on his agenda announced last February for "Building a Better America." But there is still much that must be done to achieve his goals. First, we must enforce tough spending restraint to create a more realistic match of spending claims with public resources generated by a tax system that the American people will support. The Bush Administration budget for FY 1991 calls for outlays of $1,233.3 billion, an increase of only $36.1 billion over the estimated spending this year. This modest increase of 3.0 percent in FY 1991 continues the recent slowdown in the growth of budget outlays. For example, for the years FY 1976 through FY 1982, Federal spending increased at a rapid annual rate of 11.8 percent, a pace more rapid than the average nominal GNP growth rate of 10.5 percent. During the last seven years, the growth rate of government spending has slowed to an annual pace of 6.3 percent while the nominal GNP has increased at an average 7.3 percent rate. Our budget proposal calls for further deceleration in the growth of spending to an annual rate of 4.4 percent through FY 1995, or nearly 2-1/2 percentage points slower than the projected growth rate of the nominal GNP. As the overall economy grows more rapidly than the pace of Federal budget increases, the relative burden of government spending is eased.

Second, costly new initiatives that reach beyond our prospective public resources are avoided. There are, of course, a large number of existing and potential claims against our budget resources. The difficult part is ranking the proposals so that we allocate government funds to the highest priorities.

Third, within the overall context of spending restraint, there will be continuing changes in the rankings of competing claims. This process reflects the familiar axiom that "every good thing is not equally good." Examination of the three major spending components of the budget demonstrates the realignment process that is underway. The prospective growth of defense spending has been constrained, reflecting changing international conditions. During the five-year budget plan presented, defense spending is projected to rise from $296.3 billion in FY 1990 to $318.6 billion by FY 1995. As a result, defense spending as a share of the GNP will decline from 5.4 percent in 1990 to 4.2 percent in 1995. As a share of budget outlays, defense spending will drop from 24.8 percent of the total in FY 1990 to 21.6 percent by FY 1995. Stated in constant 1982 dollars, defense spending is projected to decline from $256 billion in FY 1989 to $241 billion in FY 1990 and to $214 billion by FY 1995. The entitlements and mandatory spending programs are projected to grow approximately at the rate of inflation. Spending for nondefense discretionary programs is expected to have the largest relative gain.

Proposed Changes in Budget Spending Categories
For FY 1991 From FY 1990

(billions of dollars)

	FY 1990	FY 1991	Dollar Change	Percent Change
Defense	296.3	303.3	+ 6.9	+2.3
Nondefense Discretionary Programs	201.6	213.6	+12.0	+6.0
Entitlements and Mandatory Programs	562.5	589.7	+27.2	+4.8

Fourth, within the overall strategy of rigorous spending restraint, we must meet our existing responsibilities while addressing new opportunities and needs.

REVENUE ESTIMATES AND TAX POLICY INITIATIVES

The Bush Administration's fiscal policies contained in the FY 1991 budget build upon the major reforms adopted in the Tax Reform Act of 1986. Treasury projects budget revenues of $1,170.2 billion for FY 1991. This is $96.8 higher than the estimated FY 1990 total, following an anticipated increase of $82.8 billion during the current fiscal year and $81.7 billion last year. The estimated 9.0 percent increase in revenues in FY 1991 is based on sustained economic growth and several important tax policy initiatives. Revenue increases also are projected to continue in future budget years (see Exhibit 9 for revenue estimates).

THE SAVINGS AND ECONOMIC GROWTH ACT

In his State of the Union address, President Bush announced The Savings and Economic Growth Act. This legislation is designed to promote long-term investment, to encourage Americans to save, and to make it easier for them to purchase their first home. The President's proposal has three components.

Family Savings Accounts

An important goal for the 1990s is to increase the rate of growth of America's productive capacity. A higher growth rate will significantly increase living standards for both current and future generations. More saving is needed, however, to finance increases in our productive capacity. We believe that the Federal Government should foster an environment that is conducive to saving, and we have a plan to achieve this objective.

The Family Savings Account (FSA) proposal will allow nondeductible contributions of up to $2,500 per taxpayer with a maximum of two accounts per family. Contributions will be allowed for single people with adjusted gross incomes (AGIs) below $60,000, for those filing as heads of households with AGIs below $100,000, and for married couples filing joint returns with AGIs below $120,000. These contributions will be allowed in addition to contributions to qualified pension plans, IRAs, 401(k) plans, and other tax-favored savings plans.

After meeting the required seven-year holding period, all savings, including the accumulated earnings, can be withdrawn tax-free. Withdrawals of savings within three years of the time the contribution was made will result in a 10-percent excise tax penalty and an income tax on the associated earnings. Earnings on funds withdrawn between three and seven years after contribution will be subject only to income tax with no excise tax penalty.

We believe that the FSA will provide a significant savings incentive, at a cost to the Treasury that is less than many other savings proposals. During fiscal year 1991, the revenue loss would be only $200 million; for the entire period 1990-95, it would be $4.7 billion. These estimates refer only to possible revenue losses and do not include prospective revenue gains resulting from increased investment and economic growth.

The new FSAs will provide a simple and understandable program for Americans to save and to see the benefits of changing their behavior. The time limit is short enough to focus attention on specific personal goals--saving to buy a home, preparing for education costs, for building a financial reserve to protect against unexpected events, or for any high-priority goals. This is a program that Americans can understand and can participate in without having to wait for long periods to have access to their savings.

From the Government's perspective, the FSA does not cause large revenue losses at the beginning of the program because the contributions are not tax deductible. Instead, the earnings created by the contributions to FSAs will be exempt from taxes. This approach is prudent because we can evaluate the results as we proceed.

Capital Gains Tax Rates

The President's first initiative for enhancing saving and investment involves a permanent reduction and restructuring of the capital gains tax rate. To encourage Americans to invest for longer periods of time, we believe that the tax rate for capital gains on real estate, timber, homes, farms, land and corporate stock should be reduced based on the length of time an asset has been held. If an investment is held for one year, a 10 percent exclusion of the capital gain from taxable income would be permitted. If the asset had been held for two years, an exclusion of 20 percent would be permitted. The maximum exclusion would be 30 percent of the gain for assets held three or more years. For a taxpayer in the 28 percent bracket, this proposal would generally result in effective tax rates of 25.2 percent, 22.4 percent, and 19.6 percent, respectively.

For the balance of 1990, the 30 percent exclusion would apply to all qualified capital assets held at least one year. For assets disposed of in 1991, the 30 percent exclusion would apply to assets held at least two years, and the 20 percent exclusion would apply to assets held at least one year but less than two years. The general rule would apply in 1992 and all years thereafter. The excluded gains would be subject to the alternative minimum tax. Prior depreciation deductions would be recaptured in full at ordinary rates of tax.

The Bush Administration believes that a reduction in the tax rate on capital gains would have several beneficial effects:

- The capital gains tax rate is an important component of the cost of capital, which in turn directly affects the ability of U.S. companies to compete worldwide. Our major trading partners already have either a lower capital gains tax rate or no tax on capital gains at all. By reducing capital gains tax rates, we will enhance our ability to compete.

- Individuals will invest in growing businesses only when they believe they will reap an adequate reward if the venture succeeds. By reducing the tax rate on capital gains, we will encourage venture capital investments and entrepreneurial activities. The result will be a better economy, more jobs, and a higher standard of living for all Americans.

- The sliding scale of capital gains tax rates would provide incentives for longer-term investments. To the extent individuals are rewarded for holding their investments longer, stability in the marketplace is enhanced. Stable investment opportunities will increase the creation of jobs and improve economic performance.

- The benefits of a capital gains tax rate cut would be widely distributed throughout the population. In a typical year, 14 million tax returns (representing approximately 26 million taxpayers) report income from the sale of capital assets. Based on 1987 tax data, about 41 percent of net long-term capital gains were reported by taxpayers with adjusted gross income, excluding capital gains or losses, of under $50,000. Furthermore, it is estimated that nearly one-half of all taxpayers report capital gains in one year or another during their life.

- Our capital gains tax rate reduction will raise revenues for deficit reduction--$4.9 billion in fiscal year 1991 and $12.5 billion during the period 1990-1995.

Home Ownership Initiative

As I have already noted, individuals can continue to use current-law IRAs. To encourage home purchases, we also propose that the 10-percent excise tax on early withdrawals of up to $10,000 from these IRAs be waived if the funds withdrawn are used for a first-time purchase of an eligible home. This would enhance the attractiveness of IRAs as a vehicle for savings.

OTHER INITIATIVES

Incentives for Research and Experimentation

Technological change plays a central role in economic growth. The Government has an important function in promoting innovation and basic research. In order to do so, we believe that the 20-percent Research and Experimentation (R&E) tax credit, which is set to expire on December 31, 1990, should be made permanent. Research is inherently a long-term process. Making the R&E tax credit permanent will permit businesses to begin projects without having to worry that the credit will be withdrawn in the future. For the same reasons, we propose to make permanent the current rules for the allocation of research expenses between U.S. and foreign-source income. Permanent R&E expense allocation rules are essential for U.S. companies to plan for the long-term costs of their R&E programs.

Internal Revenue Service (IRS) Items

The IRS currently allocates substantial resources to direct enforcement of the tax laws. The IRS has identified a number of enforcement areas in which receipts could be increased by introducing management reforms which would change the allocation of existing resources within the IRS. In most cases, these management reforms would accelerate the receipt of taxes, penalties, and interest. In addition, the IRS has identified a number of ways in which enforcement could be improved by the application of additional resources. Therefore, we propose an increase in IRS funding for tax-law enforcement and for collection of delinquent taxes, penalties, and interest. Taken together, the new resources and the management reforms would lead to revenue increases of $3 billion in FY 1991.

Finally, we have proposed specific user fees. These fees are intended to allocate the costs of government facilities and services to the actual beneficiaries. Specific exemptions and deductions also are included to encourage certain actions.

Extensions of Current Programs

We also propose the extension of certain programs that would otherwise expire:

- The 3 percent excise tax on telephone service, currently scheduled to expire after December 31, 1990, should be made permanent.

- The low-income housing credit encourages the private sector to construct and rehabilitate the Nation's housing stock and make it available to the working poor and low-income income families. It should be extended through 1991.

- The deduction for 25 percent of health insurance costs by self-employed individuals should be made permanent. This provision would mitigate the disparity between the owners of incorporated and nonincorporated businesses.

A more detailed description of all the receipts proposals is included in the Treasury Department's publication, General Explanations of the President's Budget Proposals Affecting Receipts.

The Bush Administration believes that our budget goals can be achieved without increasing tax burdens on the American people. The pledge to submit a budget proposal that meets the statutory target without increasing taxes has been fulfilled. The budget outlay and revenue proposals presented in the FY 1991 budget are intended to sustain the impressive economic progress of the last seven years.

CONCLUSIONS

The realities of domestic and international responsibilities indicate that budget plans must be made in the context of continuing fiscal restraint. After many years of simply adding new government spending programs to existing budget claims, we must rearrange existing priorities.

The FY 1991 budget proposals, and the five-year planning horizon, concentrate on two priorities.

- Reduce future Federal budget deficits.

- Reallocate resources into investments in people, technology, and capital goods to prepare for the future.

The proposed budget will achieve a significant reduction in the deficit to $63.1 billion in FY 1991, meeting the statutory target. Reaching this ambitious goal will yield several major benefits.

- It will curtail Federal credit demands in the financial markets, leading to better access to capital and lower interest rates for consumers, home buyers, business firms, and state and local governments.

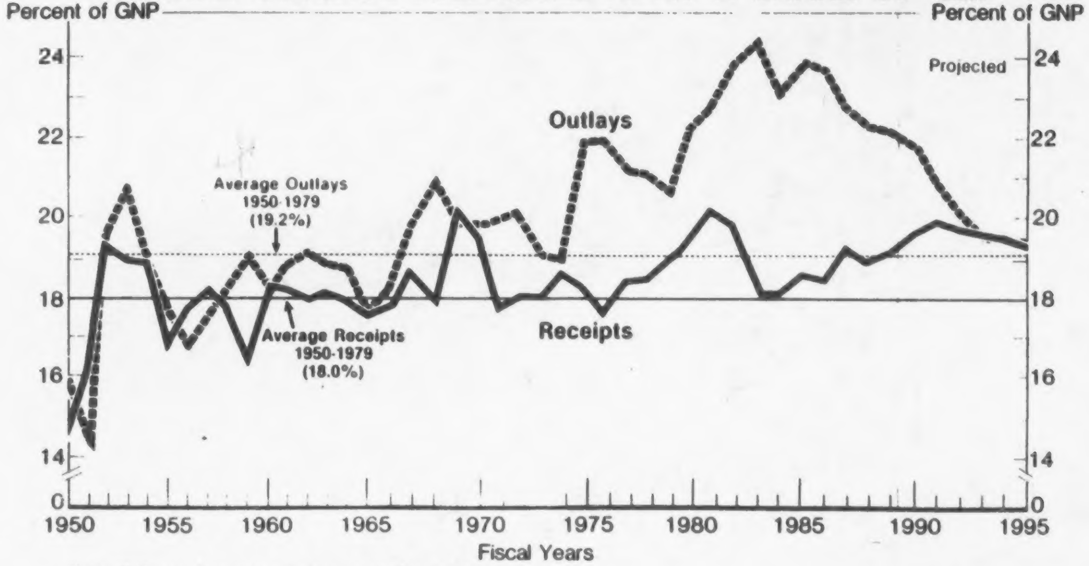
- It will reduce the share of total national output allocated to government and shift resources into the private sector creating more jobs and improving our international competitiveness.
- It will help ease the burden of future interest payments on the accumulated national debt.

Achieving the dual goals of reducing prospective budget deficits and realigning spending priorities is dependent upon sustaining economic growth that provides tax revenues and creates investment opportunities. Our budget proposals assume moderate growth in the 2-1/2 percent zone in 1990, although the quarterly pattern may fluctuate, and that inflation remains under control. This outcome will lead to the eighth year of continuous economic expansion. A second benefit of continued budget spending restraint and deficit reduction will be the increased flexibility provided to the Federal Reserve System in the management of monetary policy.

Finally, the most important aspect of the FY 1991 budget is the emphasis placed on long-term national goals. Economic events have demonstrated the relationship between saving and investment and the problems created by our disappointing national saving rate. The FY 1991 budget provides a package of incentives to enhance national saving and investment. When combined with a significant reduction of budget deficits, these recommendations will improve the national saving rate without increasing tax burdens on the American people. The Bush Administration is prepared to work with Congress to enact a responsible budget for FY 1991.

EXHIBIT 1

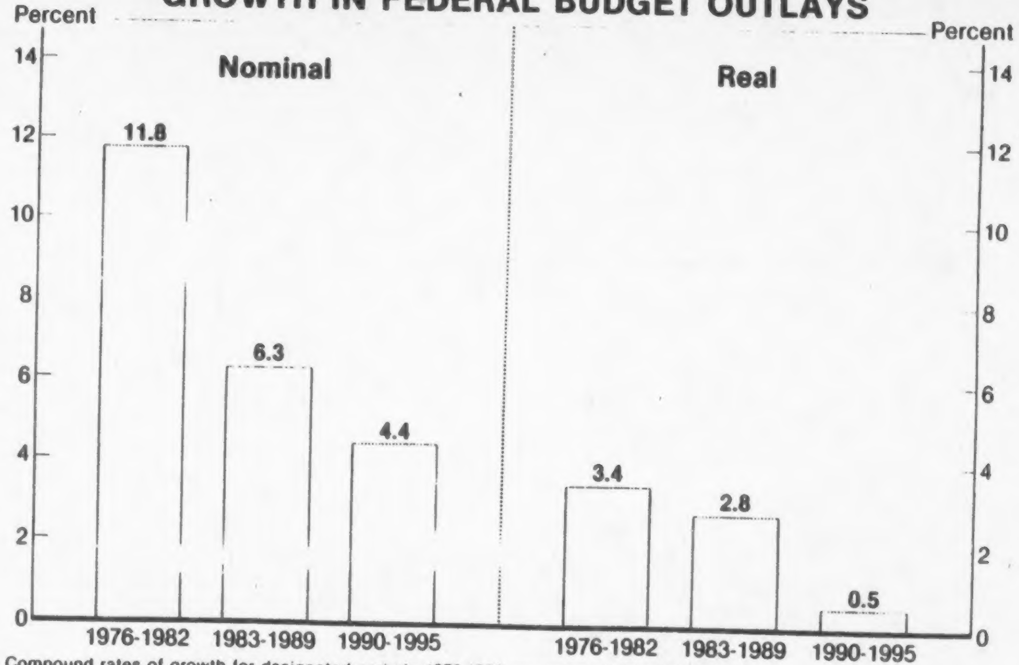
FEDERAL OUTLAYS AND RECEIPTS AS A SHARE OF GNP



Note: Outlays and receipts include on- and off-budget items.

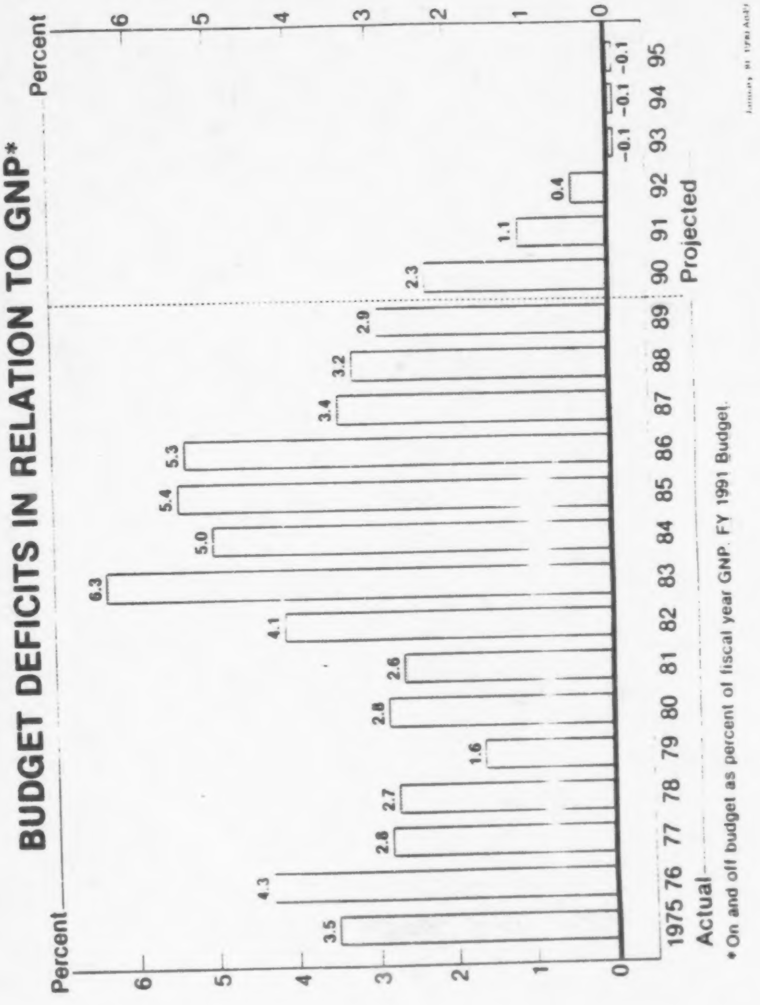
EXHIBIT 2

GROWTH IN FEDERAL BUDGET OUTLAYS



Compound rates of growth for designated periods 1976-1989 are actual; 1990-1995 projected.

EXHIBIT 3

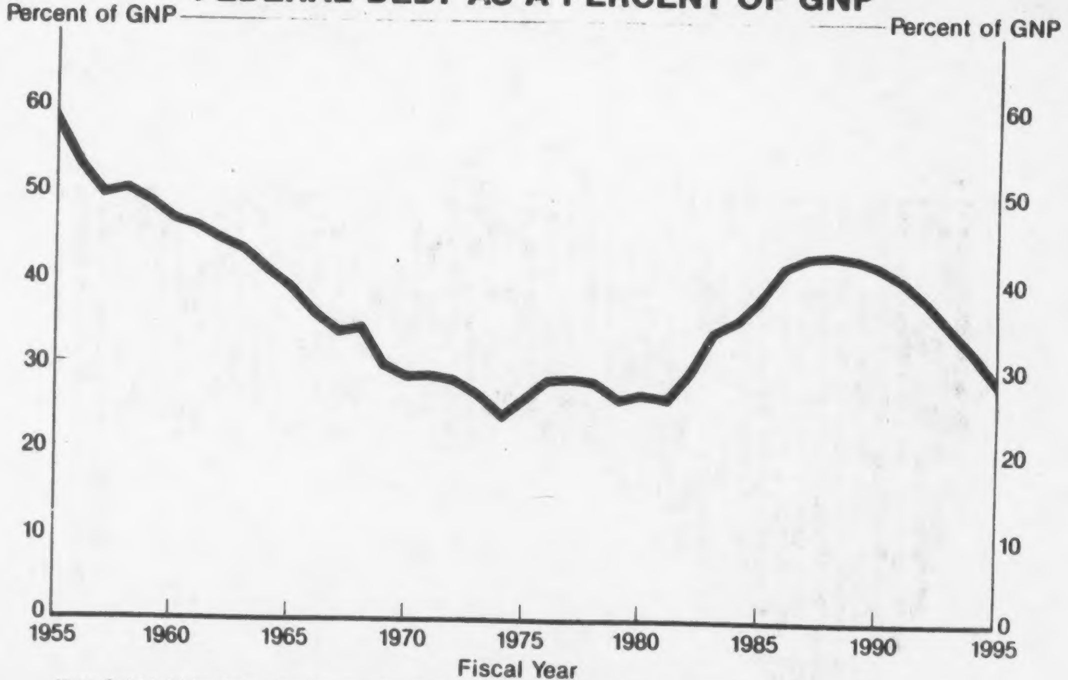


BUDGET DEFICITS IN RELATION TO GNP*

* On and off budget as percent of fiscal year GNP. FY 1991 Budget.

EXHIBIT 4

FEDERAL DEBT AS A PERCENT OF GNP



Note: Debt held by the public, inluding the Federal Reserve. Administration forecasts for FY-1990 thru FY-1995.

January [illegible] 1990 [illegible]

EXHIBIT 5

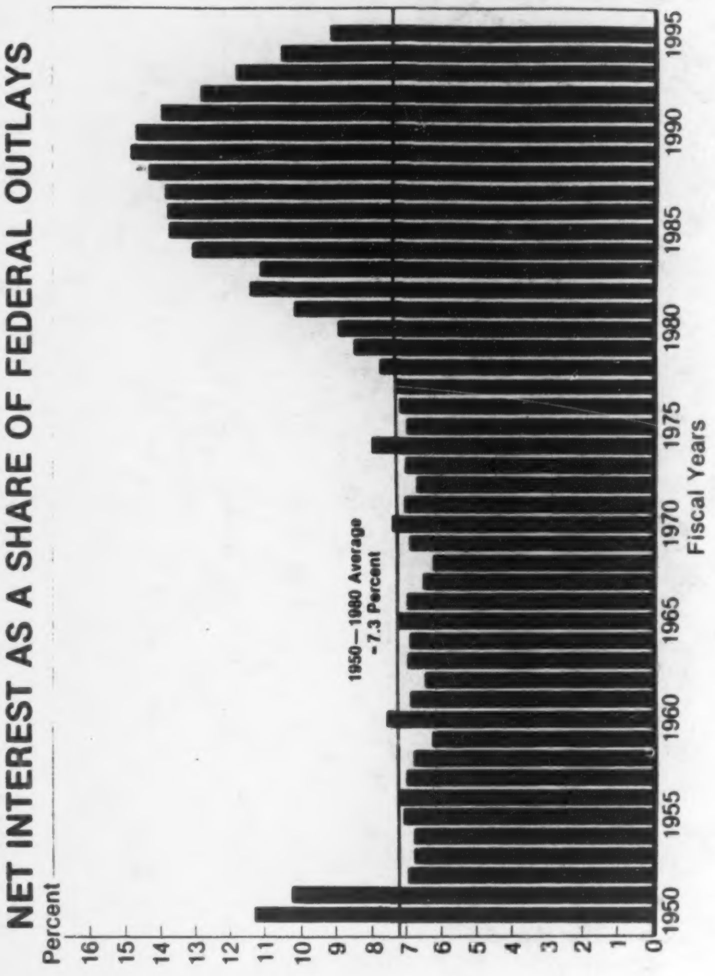

NET INTEREST AS A SHARE OF FEDERAL OUTLAYS
Percent
16
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
1950—1980 Average
=7.3 Percent
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
Fiscal Years

EXHIBIT 6

U.S. AND FOREIGN BUDGET DEFICITS

(Percent of GNP; Total Government)

	1988
Canada	—2.6
France	—1.3
Germany	—2.1
Italy	—10.6
Japan	+1.3
United Kingdom	+0.8
United States	—2.0
Federal	—3.0
State and Local	+1.0

Source: OECD [illegible] Outlook [illegible]

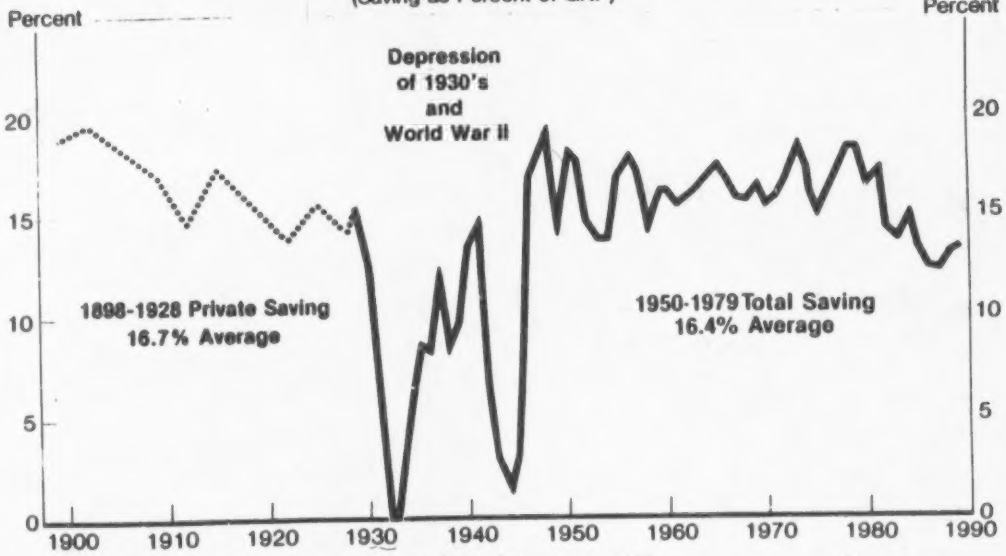
Total Government is aggregate deficit or surplus of government sector (federal, state, and local) Data are on a national income account basis and are for the calendar year.

[illegible]

EXHIBIT 7

U.S. GROSS SAVING RATIO, 1898-1989

(Saving as Percent of GNP)



Note: 1898-1928 data from David and Scadding, Journal of Political Economy, April 1974.
Data following 1928 are from U.S. Department of Commerce.

January 10 1990 [illegible]

EXHIBIT 8

Gross Saving and Investment as a Share of Gross National Product

	1950's	1960's	1970's	1980-88	1987	1988	1989(p)
Gross Domestic Saving	16.1	16.3	16.7	14.1	12.2	13.2	13.4
Private[1]	16.5	17.1	18.4	18.0	16.1	16.6	16.9
Personal[1]	5.1	5.1	6.4	5.1	3.7	4.4	5.4
Corporate Undist. Profits	2.8	3.5	2.5	1.7	1.7	1.6	0.9
Depreciation Allowances	8.7	8.5	9.6	11.0	10.8	10.5	10.6
Government[1]	-0.4	−0.8	−1.8	−3.8	−3.8	−3.4	−3.5
Federal	0.1	−0.3	−1.7	−3.9	−3.6	−3.0	−2.9
State & Local[1]	−0.6	−0.5	0.0	0.1	−0.3	−0.4	−0.6
Gross Investment	16.3	16.2	16.7	14.2	12.1	13.0	12.9
Gross Private Domestic	16.2	15.5	16.4	15.8	15.5	15.4	14.8
Business Fixed	9.6	9.9	10.7	10.9	9.8	10.0	9.8
Net Foreign	0.1	0.6	0.2	−1.6	−3.3	−2.4	−1.9
ADDENDUM:							
Net Domestic Saving[2]	8.1	8.6	7.9	3.4	1.7	3.0	3.2
Private[1]	8.6	9.4	9.8	7.7	6.0	6.8	7.1
Government[1]	−0.5	−0.8	−1.9	−4.3	−4.3	−3.8	−3.9
Personal Saving Rate[3]	6.8	6.7	8.0	5.4	3.2	4.2	5.5

Note: Small difference between gross domestic saving and gross domestic investment represents the statistical discrepancy. Other components may not add exactly to totals due to rounding.

1. Employee pension funds of state and local governments are allocated to personal saving to match the treatment of private pension funds.
2. Net saving equals gross saving minus depreciation allowances. It is shown as a share of net national product (GNP minus depreciation)
3. Personal saving as a percent of disposable personal income

p preliminary

EXHIBIT 9

PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS

	Fiscal Years					
	1990	1991	1992	1993	1994	1995
			($'s in billions)			
Capital Gains Tax Rate for Individuals	0.5	4.9	2.8	1.2	1.7	1.4
Family Savings Accounts	—*	—0.2	—0.6	—1.0	—1.3	—1.6
Permanent Research and Experimentation Tax Credit	—0.1	—0.5	—0.9	—1.1	—1.3	—1.6
Research and Experimentation Expense Allocation Rules	0.0	—0.4	—0.7	—0.8	—0.8	—0.9
Energy Tax Incentives						
Credit for Intangible Drilling Expenses	0.0	—0.2	—0.3	—0.3	—0.4	—0.4
Credit for Tertiary Recovery	0.0	—*	—*	—*	—*	—*
Modify Oil and Gas Depletion Rules	0.0	—*	—*	—*	—*	—*
Revise AMT for Exploratory Drilling by Independents	0.0	—0.1	—0.1	—0.1	—0.1	—0.1
Enterprise Zone Tax Incentives	0.0	—0.1	—0.2	—0.3	—0.5	—0.8
Establish Refundable Child and Dependent Care Tax Credit	0.0	—*	—*	—*	—0.1	—0.1
Deduction for Special Needs Adoption	0.0	—*	—*	—*	—*	—*
Penalty-Free IRA Withdrawals for First-Time Home Buyers	—*	—*	—0.1	—0.1	—0.1	—0.1
Extension of Low Income Housing Credit	—*	—0.1	—0.3	—0.4	—0.4	—0.4
Extend Special Rules for Health Insurance Costs of Self Employed Individuals	—*	—0.2	—0.4	—0.5	—0.5	—0.6
Extend Social Security Coverage to Certain Employees of State and Local Governments	0.0	2.1	2.2	2.3	2.5	2.7
Medicare Hospital Insurance (HI) for State and Local Employees	0.0	1.7	1.7	1.7	1.7	1.6
Airport and Airway Trust Fund	0.0	0.5	0.8	0.9	0.9	1.0
Extension of Telephone Excise Tax	0.0	1.5	2.5	2.7	2.9	3.1

January 30, 1990 [illegible]

PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS

(Continued)

	Fiscal Years 1990	1991	1992	1993	1994	1995
	($'s in billions)					
Treatment of Salvage Value by Property and Casualty Companies	0.2	0.2	0.2	0.2	0.1	0.1
Payroll Tax Deposit Stabilization	0.0	0.9	2.2	—3.1	0.0	0.0
Permit Limited Use of Excess Pension Funds to Pay Retiree Health Benefits	0.0	0.2	0.4	0.2	0.0	0.0
Initiate IRS Management Reforms	0.1	2.5	1.1	0.5	—*	—0.4
Increase IRS Enforcement Funding	0.0	0.5	0.8	1.3	1.5	1.6
Miscellaneous Proposals Affecting Receipts:						
Increase D.C. Contributions of CSRS	0.0	*	*	*	0.1	0.1
Increase Ad Valorem Fees on Shippers	0.0	0.3	0.3	0.3	0.4	0.4
Increase and Expand SEC Fees	*	0.1	0.1	0.1	0.1	0.1
Modify Collection Period of Telephone Excise Tax	0.0	0.1	*	*	*	*
Extend Abandoned Mine Reclamation Fees	0.0	0.0	0.1	0.3	0.3	0.3
Establish CFTC Fee	0.0	*	*	*	0.1	0.1
Change Collection Point for Liquor Occupation Taxes	0.0	*	*	*	*	*
Extend OASDHI to D.C. Employees	0.0	*	*	*	*	*
Extend IRS User Fee	0.0	0.1	0.1	0.1	0.1	0.1
Establish FEMA Fees	*	*	*	*	*	*
Extend and Expand Railroad UI Reimbursable Status	0.0	—*	—*	0.0	—*	—*
Modify Federal Reserve Reimbursement	0.0	0.1	0.1	0.1	0.1	0.1
Delay Federal Pay Raise	0.0	—*	—0.1	—0.1	—0.1	—0.1
Establish Corps of Engineers Fees	0.0	*	*	*	*	*
Other	0.0	—0.1	—0.2	—*	—*	—*

* Revenue gain of less than $50 million.

—* Revenue loss of less than $50 million.

[illegible]

Chairman SASSER. We will now turn to Dr. Boskin.

STATEMENT OF DR. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. BOSKIN. Thank you, Mr. Chairman. Chairman Sasser, Senator Domenici, and other distinguished members of the committee, it is a pleasure to appear before you today to discuss the administration's economic outlook and programs and their relation to the budget. I will also briefly discuss, at your explicit written request, developments in Eastern Europe. I will foreshorten my remarks and ask that the full set of comments that I prepared in writing be entered in the record. I will also try not to repeat the statements made by Secretary Brady which I am in full concurrence with, and he has stated so well.

Let me begin by saying that the administration has developed a new set of forecasts for the U.S. economy. Much attention has already focused on the administration's economic outlook. I tend to think the outlook has broader views and purposes than just how it affects budget outcomes, but at this time of the year I suppose that is the main focus. I would emphasize that it does frame our thinking on a variety of other issues, a point I will return to later on. I should also emphasize the budget outcomes, how and how much we spend, how and how much we tax as well as the path of the budget deficit affect on the allocation of the entire gross national product, the course of the economy, and prospects for the Nation's future economic well-being.

In my written testimony as well as in the budget, there are a group of tables that outline the administration's short and longer-term economic projections. The most important point to make, I think, is that the result of a comprehensive review by the troika agencies (my colleagues not only in the Council of Economic Advisors, but in the Treasury Department, and the Office of Management and Budget, as well as some input from the Commerce Department) was to change the outlook only in some modest detail from that presented in our midsession review last July. That is primarily because the economy has evolved thus far almost exactly as we had envisaged at that time.

The current projection reflects our broad assessment that the U.S. economy overall and over the long-run is healthy. It also reflects our view that the administration's approach to policy—emphasizing free market, sensible regulation, increased national saving and policies that take the long view—best promotes sustained economic growth. Our primary economic policy goal is to enhance the ability of the U.S. economy to grow, enhance potential growth, and then make sure we spend a larger fraction of our time operating at the economy's potential.

It is important to understand these projections and forecasts are a consistent package with the budget. That is, they assume in broad outline that the President's proposals in the budget, such as meeting Gramm-Rudman-Hollings' targets through 1993, making a clear credible commitment to reducing the national debt thereafter through the social security integrity and debt reduction fund, adopting the saving and growth incentives that Secretary Brady has mentioned, are adopted. That is always the case in administration's economic forecasts, and it is one thing to keep in mind when comparing administration forecasts with those of the Congressional Budget Office or private forecasters who generate their own set of baseline assumptions about how policy will evolve.

Our forecasts assume the President's policies or their economic equivalents will be adopted. I also might say that they are conditional on rejecting policies which would have adverse consequences on the economy such as yanking huge amounts of revenue out of the revenue base or piling on, if I can use a football analogy, huge additional costs for trivial additional environmental benefits as the Clean Air Act passes its way through the legislative process. The economic assumptions reflect our view that after a period of slower economic growth in late 1989-early 1990, the economy will rebound as 1990 progresses and thereafter.

Before turning to those economic assumptions, I might just say a word or two about the fourth quarter of 1989 since most attention has focused on the low rate of real GNP growth in the fourth quarter. Fourth quarter growth was estimated at only a half a percent at an annual rate by the Commerce Department in its first of three consecutive estimates which are revised as more data become available. This increase brought real GNP growth year over year, 1989 over 1988, to 2.9 percent, 2.4 percent on a fourth over fourth basis. The slower growth in the fourth quarter was not unexpected. We have expected it and all of us have said in our speeches that we expect a period of slower growth—and the President has stated—after a period of slower growth we expect the economy to rebound.

It is important to point out that there are several forces at work that would naturally lead to somewhat slower growth in addition to some very specific forces that affected the latter part of 1989. Part of the slower growth was in response to the tightening of monetary policy that occurred between March 1988 and March 1989. The tightening was designed to reduce the risk of an accelerating inflation perceived to be concomitant to the rapid growth of the economy in 1987 and 1988.

In the short-run, this tightening is reflected in a more sluggish pace of growth. Over the longer period of time, the containment and eventual reduction of inflation is an important prerequisite for long-term growth. Every recession since World War II has been preceded by a sharp run-up in inflation. The slower growth in real Federal Government purchases of goods and services in 1989, an important result of deficit reduction efforts, also contributed modestly to slower growth in the short-run. Over the long-run it will free up productive resources for use in the private sector which will lead to higher growth eventually.

Slowing in the fourth quarter was also caused by several important special factors, not all of which will persist. For example, the Boeing Co. had a strike for 6 weeks in the fourth quarter, and is such a major producer that the Boeing strike alone subtracted about a half percentage point from fourth quarter growth relative to continued production. Boeing is now back at work. Obviously there are also the two natural disasters, Hurricane Hugo and the Loma Prieta earthquake. In addition, automobile sales were very sluggish in the fourth quarter, partly because automobile sales were pushed forward into the third quarter with a huge incentive program.

So I think an accurate assessment would be that the third quarter GNP growth of 3 percent somewhat overstated actual performance. The fourth quarter was probably slightly understated by these numbers. While we expect the economy to be healthy, that is not to suggest that there are not some areas that are weak. I have mentioned automobiles and housing; the interest sensitive sectors of the economy have been weak in recent months.

Let me then turn to the forecast for 1990 and 1991. For 1990 as a whole we expect GNP to expand around 2.6 percent on a fourth quarter to fourth quarter basis, small increase from last year's modest growth.

That is somewhat below our estimate of the economy's potential growth of around 3 percent, and after 1989 and 1990—a little below—we expect the economy then to speed up a little bit and catch up with the economy's growth potential over the next year or so. I want to emphasize as we discuss whether these economic projections are sensible or accurate or pessimistic or optimistic that 2.6 percent growth is only about 80 percent of the average post-World War II real growth rate, a period that includes seven recessions.

So predicting continued growth in 1990 at a level that is somewhat below the postwar average in 1991 will be at the postwar average. We expect in the short term a very small increase in unemployment, and we expect inflation to be down slightly. The temporary period of increased slack in labor markets and plant utilization will produce, we believe a small decline in inflation this year, and as the economy then continues its path, we expect inflation to decline over the longer term as inflationary expectations abate.

It is important to repeat that credible fiscal and monetary policies form the basis for the administration's projections, for the interest rate projections as well as the forecast and economic outlook as a whole. Adoption of the President's proposals, strong commitment, renewed commitment, rededicated and redoubled commitment—as Secretary Brady has suggested—to meeting the Gramm-Rudman-Hollings' targets, and moving beyond them in 1993 and beyond—as Senator Domenici has suggested—to reduce the national debt should send a strong signal to convince investors in the United States and worldwide that government's drain on credit markets will be on a long-term downtrend.

That means that we can expect real interest rates to decline upon adoption of such proposals and a credible monetary policy that sustains growth will be able to do so while reducing inflation and interest rates. Let me then talk about the forecast accuracy for a moment because this is a typical ritual at the time of the year, and while we have a new team making these forecasts, I understand reputations are hard to shake. This is not meant at all to gloat. There is a combination of factors why we were very accurate. Undoubtedly some of that was luck.

But I do want to mention, and this is in table 3 if you are interested in getting the exact——

Chairman **Sasser**. Now these are the midterm corrections that came last year?

Dr. Boskin. These are the first full Bush administration forecasts which were done in the midsession.

Chairman Sasser. Yes. These are not the projections on which we put together the 1990 budget.

Dr. Boskin. These are the midsession review forecasts. That is correct. At that time——

Senator Domenici. Are these the ones that are almost right on?

Dr. Boskin. That is correct, Senator Domenici. Thank you.

Senator Domenici. We got them yesterday, but you can give them to us again.

Dr. Boskin. OK.

Senator Domenici. Did we not, Mr. Chairman?

Chairman Sasser. Well, yes, we got them yesterday, and Mr. Darman has been talking about them ad infinitum for the last week, but my point was these were the midterm corrections that came in July.

Dr. Boskin. These are the midsession review forecast numbers.

Chairman Sasser. Right.

Senator Domenici. I would like to hear them again, however. [Laughter.]

I know you might not want to, Mr. Chairman, but I think we should hear them again.

Chairman Sasser. No, I am delighted. I am delighted. I am always pleased when the Council of Economic Advisers is accurate. I just made the comment yesterday to Mr. Darman that we would hope that the economic assumptions that he presents us when he makes his budget are going to be the same as we get in midterm when we in the Congress have to make our budget.

Dr. Boskin. Well, Senator Sasser, I hope so too. I think if the economy does more or less as we expect and if we move toward adoption of sensible fiscal and monetary policies including the adoption of the President's budget proposals, we believe that it is unlikely there will be a large revision at midsession. But the reason we have the midsession is to take account of what has happened both to the economy and legislatively in the intervening half year.

Let me just summarize very briefly. The economy behaved in 1989 almost exactly as we had expected. And the forecast, therefore, remains relatively unchanged. For year over year GNP growth, we were exactly accurate, 2.9 percent; for unemployment we were exactly accurate to the tenth, 5.2 percent; for long-term interest rates, we were exact, 8.5 percent. We were off by a tenth on short-term interest rates, and while we were criticized at midsession for being too optimistic about the ability to reduce inflation in the second half of 1989 relative to the first half, indeed we were a little too pessimistic. Inflation came in even lower than we had forecast.

It was the most accurate midsession forecast in the history of midsession forecasts. And since we are often compared to the blue chip forecasters, who are in the business and who do not necessarily make assumptions about the administration's proposals being adopted, it is worth noting that our midsession forecast was more accurate than each and every of the 52 private blue chip forecasters' forecasts made at the same time. They revise theirs monthly.

We do ours semiannually. I think it is also worth noting that while we tracked the economy well in 1989 and undoubtedly there was some luck in that, sir, I do not pretend to suggest that this will happen year after year. I certainly hope there is never a year in which we are less accurate than all 52. I do believe that we should pay some attention to this if we start having labels about who is being optimistic and pessimistic, and for comparison since the newspapers tend to this all the way, I would like just to give an idea of our forecast record relative to the CBO.

I have a deep regard for the professional integrity and quality of the people at the CBO and by symmetry I hope that would work both ways. But over the last several years, they have been very pessimistic relative to actual outcomes. It turns out they underestimated real growth all 3 years in the last 3 years, overestimated inflation all three times and on interest rates in the last 9 years they were too high on 3-month T-bills 8 of the last 9 years.

I do not suggest that they are not doing the best job possible. Forecasting is an inexact science. Trying to get this to the tenth is beyond the ability of science to do, but I do think it is important that we keep this in mind. In 1990, we expect the expansion to continue and the economy move back to its potential. Over the long-run we expect productivity growth to enable us to achieve our long-term economic growth potential of around 3-percent. Indeed, we hope we will be adopting policies that will enable us to enhance that potential.

Let me just say one or two words about the administration's economic goals. Secretary Brady has emphasized the fiscal side. Let me just emphasize that the health of the economy depends also on monetary policy, on trade policy, and regulatory policy, and we need to be moving to more open markets, not more closed markets. We need to make sure that we eliminate undesirable regulation, and where regulation is necessary, for example, in the environment, that we select goals that balance benefits with costs and employ means to achieve them that enable our workers and firms the flexibility to do so without substantial disruption.

You asked me specifically to comment on Eastern Europe, and I have a rather lengthy response in writing. I will just summarize it briefly by saying that the United States together with other countries has played in my view an important role in beginning to assist the emerging transition in the economies of Eastern Europe, particularly Poland and Hungary with the SEED Act passed last year to begin to make that difficult transition. Moving toward market-oriented reforms is the only hope these people have for sustained long-run improvements in their standard of living. But over the short-run obviously there will be some difficult transition problem.

A useful analogy might be to say they are trying to get on a highway, and once on that highway, and once able to go at the speed limit for some length of time, they will have much higher standards of living for their people. But they have to navigate congested city traffic with potholes to get on it. And we are working—as you know, I am one of the coordinators along with Deputy Secretary Robson and Deputy Secretary Eagleburger—as part of the administration's efforts, to make sure we maximize the value of the assistance—financial, technical, and intellectual--that we provide to these economies, in the case of the SEED Act, Poland and Hungary.

Secretary Eagleburger, Secretary Robson, and I will be going to Eastern Europe later on in the next month or two to make further progress in this regard. Let me finally just say that the initial response to some of our proposals and one in particular that the Treasury Department played the key role in, the stabilization fund for the move to convertible currency pursuant to the devaluation of the zloty in Poland, thus far appears to have worked very well. In conjunction with the International Monetary Fund and other international financial institutions, the Poles have worked out a very comprehensive reform program, a key component of which is to try to break the back of their hyperinflation.

They devalued the zloty. They moved to convertibility. And the stabilization fund to which we contributed $200 million, and our Treasury Department worked with our allies to put together, has been an important factor in restoring confidence. There has been no need thus far to call on that exchange stabilization fund. But again let me emphasize the problems are substantial in making this transition. I would emphasize two other points, Mr. Chairman. While the problems are complex and pervasive and cannot be solved quickly, that the move to market-oriented reforms are the only hope these economies have of sustained improvement, and I would also remind everyone that these economies and these societies are very diverse. Their standards of living generally are much lower than those of the industrial economies of Western Europe, let alone in the higher standards of living in the United States, but they vary a lot among themselves, and they also vary a lot to the extent to which they had begun some partial moves toward market sectors, market oriented reforms and so on.

I think it is important to bear this in mind. We are all obviously elated at the moves to pluralism and democracy in market reform that we have begun to see in Eastern Europe, and we want to make sure that we do what we can to make those moves successful. The primary component of that success obviously will be with what the indigenous peoples of those countries do themselves, the routes they wish to take, the economic capacities of their countries, and the political will they have to follow the reforms. Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you very much, Dr. Boskin.

[The prepared statement of Dr. Boskin follows:]

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

STATEMENT BY MICHAEL J. BOSKIN
CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE SENATE BUDGET COMMITTEE
February 1, 1990

THE ADMINISTRATION'S ECONOMIC OUTLOOK, BUDGET PROPOSALS AND ECONOMIC POLICIES

Chairman Sasser and Senator Domenici, and other distinguished members of the Committee, it is a pleasure to appear before you today to discuss the Administration's economic outlook and programs, and their relation to the budget. I will also discuss, at your request, developments in Eastern Europe.

The Administration has developed a new set of forecasts for the U.S. economy. Much attention focuses on the Administration's economic outlook, both as an indication of where the economy is headed for its own sake, and at this time of the year, as it affects projected budget outcomes. That's understandable and important, since the budget outcomes--how and how much we spend, how and how much we tax, as well as the path of the budget deficit--affect the allocation of the entire gross national product, the course of the economy, and prospects for the Nation's future economic well-being.

Although the economic projections contained in the tables you have before you are the result of a comprehensive review of the economic situation, the net result is an outlook that differs only in the details from our forecast presented in conjunction with the July 1989 mid-session review, which as I will discuss below has thus far turned out to be right on the mark.

The current projection reflects our broad assessment that the United States economy is healthy. It also reflects our view that the Administration's approach to policy--emphasizing free markets, sensible regulation, increased national saving, and policies that take the long view--best promotes sustained economic growth. The conditional nature of these forecasts must be emphasized: they depend critically on implementation of the Administration's economic policy proposals, especially the effort to reduce the budget deficit, balance the budget, and then reduce the national debt thereafter; as well as other proposals to expand and enhance the economy's potential. If these proposals are adopted, we should be able to achieve maximum sustainable economic growth. Government policy must enhance the economy's potential for growth and ensure that it operates more frequently at its potential than in previous decades. In designing policies to meet this goal, it is important to be ambitious but realistic. Setting the Nation's sights too low guarantees mediocre performance. Setting hopelessly unrealistic goals guarantees disappointment.

Achieving these goals is also conditional on the rejection of various proposals that would have adverse economic consequences. These include proposals that would add huge additional costs and disruption to the economy, while achieving only tiny additional environmental benefits relative to the President's clean air proposals; or would remove large amounts of revenue from the revenue base.

Economic Assumptions

Before I begin, I would like to take a moment to acknowledge the contributions of others in developing this forecast. The Administration's economic projections are result of concerted effort by the Troika agencies--the Council of Economic Advisers, the Department of the Treasury, and the Office of Management and Budget. The Department of Commerce also contributes to this process. As you know, the President stays well informed on the state of the economy, and the projections that I am about to discuss have been approved by him.

Economic Developments in 1989

You are also no doubt aware that last Friday the Department of Commerce reported that real GNP rose 0.5 percent at an annual rate in the fourth quarter of 1989. This increase brought real GNP growth on a year-over-year basis to 2.9 percent (2.4 percent on a fourth-over-fourth basis).

The slower growth in the fourth quarter was not unexpected. Indeed, I have said consistently in my speeches over the last several months that we expected growth to slow in late 1989 and early in 1990, but we expect growth to rebound later this year. There were three principal forces that led to the slowing in 1989, and we expect each of these to fade in importance in the future.

- First, growth slowed in response to the tightening in monetary policy over much of 1988 and in early 1989, which was designed to reduce the risk of an accelerating inflation. In the short run this tightening is reflected in a more sluggish pace of growth. Over a longer period of time, the containment and eventual reduction of inflation, however, is an important prerequisite for long-term growth. Each recession since World War II has been preceded by a sharp run-up in inflation, which usually causes policy responses or private sector imbalances that lead to a downturn.

- Second, a slower growth in real Federal Government purchases of goods and services--an important result of deficit-reduction efforts--also contributes modestly to slower growth in the short run. Over the long term, though, slower growth in government spending frees resources for employment in the private sector, boosting investment and leading to higher sustainable economic growth.

- Finally, a slower pace of improvement in real net exports was expected and occurred during late 1989. Again, the Administration expects that government policies directed toward increased national saving will improve the fundamental economic factors that lie behind the external deficits.

The slowing in the fourth quarter also was caused partly by some temporary special factors, which will not persist. The extremely cold weather in most parts of the Nation in December and the Boeing Company strike beginning in October and ending in late November reduced output last quarter. The Boeing strike alone is estimated to have reduced GNP growth in the fourth quarter by about one-half percentage point. Thus, you can see that the underlying pace of GNP growth in the fourth quarter is somewhat higher than the reported figure.

The return to more normal production as these special developments cease will add to growth in the first quarter of 1990. However, the lagged effects of monetary tightening 1989 are expected to continue to hold down GNP growth during the first half of 1990. We expect that by the summer interest-sensitive sectors will be responding to the easing of monetary policy that has been underway since last spring, the accumulation of inventories in the fourth quarter will be worked off, and production will begin to rise at a more rapid rate.

Forecast for 1990 and 1991:

For 1990 as a whole, we expect GNP to expand 2.6 percent on a fourth-quarter-to-fourth-quarter basis, a small increase from last year's growth. Growth at 2.6 percent is somewhat slower than our 3 percent estimate of the annual expansion of the economy's capacity to produce, and is only 4/5 of the average rate of growth the United States has experienced over the last forty years, a period that includes seven recessions. Consequently, our forecast includes a very slight increase in the unemployment rate this year, to an average of 5.4 percent.

The temporary period of increased slack in labor and plant utilization is expected to give impetus to a decline in inflation rates. The Administration forecasts that CPI inflation will edge down to 4.1 percent in 1990 from last year's 4.6 percent rate. The Administration's steady, credible macroeconomic policies should help convince wage and price setters that inflation is gradually being rolled back. Our forecast calls for slow but steady reductions in inflation over coming years.

Credible fiscal and monetary policies also form the basis for the Administration's interest rate projections and for the economic outlook as a whole. Indeed, as I noted above, our forecast is conditional on successful implementation of the President's policy proposals. The Administration is committed both to meeting the Gramm-Rudman-Hollings targets, and to strengthening the GRH process. The Administration also proposes that projected social security surpluses be dedicated to reducing the national debt. This should convince market participants that the Federal Government drain on credit markets is on a long-term downtrend. Consequently, the Administration expects that real interest rates can and will decline. Moreover, the Administration's support of a credible monetary policy that sustains growth while reducing inflation gradually and predictably will reduce the inflation premium in interest rates. For both of these reasons, the Administration expects progressive declines in interest rates in 1990 and beyond.

Turning to 1991, the Administration is projecting a pickup in GNP growth to a 3.3 percent annual rate as the economy snaps back toward its potential, after this temporary period of slower growth. This higher growth is expected to lower the unemployment rate back to 5.3 percent. Inflation next year is expected to fall slightly to 4.0 percent.

Uncertainty in the Forecast:

Let me comment on the uncertainty in the near term forecast. As I mentioned above, some forecasters, impressed by the very length of the expansion, have concluded that it is old and must end soon. But economic expansions don't come with an expiration date. While recessions can never be ruled out, economic research has shown that the likelihood of an expansion ending does not rise with its age. Rather, recessions tend to be the result of policy mistakes, adverse external shocks, or imbalances such as building inventories economy-wide. Although policy mistakes or adverse shocks are always possible, at the present time neither appears to be likely. The inventory imbalance has thus far been confined primarily to the automobile sector.

As I indicated above, monetary policy has been eased progressively over the past half year, and we expect that monetary policy will accommodate continued economic growth in 1990. Moreover, most forecasters expect healthy growth in the other major industrialized countries with relatively stable inflation; this pattern will help reinforce continued expansion here in the United States.

Some have raised concerns about the high levels of debt that have been built up in the United States in recent years. While I believe that we must pay careful attention to developments in this area, I am not of the view that current debt levels are likely to lead to recession. In assessing debt burdens, one must be careful not to simply look at book values for assets. Also important is market or replacement value. It is true that debt has increased, but so has the value of assets, and overall household net worth has risen. In addition, the ratio of corporate debt to the market value of equity is still significantly lower than peaks reached in earlier periods. While debt has increased relative to GNP, there are indications that at least part of the increase is related to innovations in financing, e.g., longer terms on loans, and may simply represent an adjustment in the level of debt without a comensurate increase in the ratio of debt service to GNP for households. There is also some evidence that a disproportionate share of the larger stock of debt has been among the households best able to service that debt. Rising debt levels are one reason to maintain our efforts to ensure that the financial system remains safe and sound, but they do not lead to the conclusion that the economic expansion will cease.

Administration 1989 Forecast Accuracy

I might also comment briefly on statements by some that Administration's forecasts are always too optimistic. Sometimes reputations are hard to shake. Although the Mid-Session forecast was viewed as more realistic than the Reagan Administration forecast we inherited, our forecast was also criticized as being "too optimistic". In fact, as the year progressed, private forecasters adjusted their forecasts closer and closer to the Administration forecast. And if you will turn to table 3, you will see that the economy behaved almost exactly as we expected in 1989.

- The Administration's forecast for (year-over-year) real GNP growth, the unemployment rate and interest rate on 10 year bonds were exactly accurate. They were off by only 0.1 percentage point for short term interest rates and, 0.2 percentage point for consumer price inflation (we were too pessimistic at mid-year).

- While economic forecasting is an inexact science and there undoubtedly was a certain amount of luck, as well as good judgement and hard work, involved in our 1989 forecast, it is instructive to note that the Administration forecast was more accurate than all 52 forecasters that are regularly surveyed by the Blue Chip Economic Indicators (see attached Table 4 and Figure 1).

- This was the most accurate forecast in the history of the Mid-Session Review of the Budget dating back to the late 1970's.

The Administration's forecast tracked the economy extremely well in 1989. While this is no guarantee it will do so in the future, it is important to remember that the Administration's economic forecast, unlike private forecasts is conditional upon the adoption of the President's economic program. Thus, the economic assumptions and the budget estimates, both of which are based on the President's proposals, are a consistent package. In contrast, private forecasters will make their own assumptions on the likelihood the President's proposals will be implemented as they work their way through the budget process.

Although our projections for 1989 turned out to be quite accurate, forecasting really is an inexact science. The range of uncertainty and its consequences deserve nearly as much attention as the forecasts themselves. For that reason, the Administration has developed alternative forecast paths that are consistent with higher growth and lower growth than those mentioned above. The higher forecast assumes 3.0 percent GNP growth in 1990 rather than the 2.6 percent in the baseline. This path would bring the average unemployment rate for 1990 down to 5.1 percent and the inflation rate up to about 4-1/2 percent. The lower path assumes 1.9 percent GNP growth and would result in average unemployment of 5.6 percent and inflation about 1/4 percentage point below that in the baseline. These paths would have a noticeable effect on the budget deficit in fiscal 1990 and a somewhat larger effect in fiscal 1991.

Longer-Run Economic Projections:

Let me conclude my discussion of the economic assumptions by sketching out the Administration's longer-run economic projection, that for the years from 1992 into the mid '90s and beyond. These projections reflect our view of fundamental demographic trends in the economy and the impact that sound policies will have on productivity. Our forecasts incorporate a standard assumption of an average increase in the labor force of 1.3 percent per year, representing some slowing from the pace of the 1980s as the incorporation of the postwar baby boom generation into the labor force is completed.

We expect that productivity growth will offset the slowdown in labor force growth, reflecting a more skilled and experienced labor force. In addition, Administration policies that promote higher national savings and lower real interest rates will lower the cost of capital, promoting increased investment in plant and equipment, and research and development. Together, these are expected to help achieve productivity growth of 1.8 percent per year. While this figure exceeds the average increase over the past two decades (which include the abysmal productivity performance of the 1970s) it is lower than long-run economic productivity growth since World War II. We think that long-term productivity growth in the early 1990s of 1.8 percent is a realistic, achievable goal; indeed, productivity increased at exactly that rate over the 1986 to 1988 period. While productivity data are not yet available for 1989, a year when there was a substantial slowing of growth to combat growing inflationary pressures, it is likely that productivity growth was considerably weaker last year. But we do not feel that this is representative of the economy's long-term growth potential.

Economic Policies

The facts, figures, and forecasts that I have discussed are important in and of themselves. We all recognize, for example, the importance of low unemployment and inflation rates and strong growth in the gross national product. But in my mind, the real significance of this forecasting exercise is the spotlight that it throws on policies. It gives us the opportunity to reflect on the potential dangers of misguided economic policies. And it makes clear what sound government policies can do to promote a healthy economy.

Let me now briefly outline the Administrations economic policy goals and address some of the specific questions you have raised about specific aspects of policy.

The Administration's fiscal, monetary, trade and regulatory policy goals are designed to achieve the maximum sustainable rate of economic growth, by both enhancing the Nation's potential output and ensuring the economy generally operates at its potential. The goals are as follows:

1) raise national saving and investment primarily by reducing the Federal budget deficit by slowing the

growth of Federal spending until the budget is balanced in fiscal year 1993, and reducing the national debt thereafter;

2) support a credible monetary policy program that sustains maximum economic growth while predictably controlling inflation;

3) continue to lead the world to freer trade and more open markets; and

4) eliminate undesirable regulation, select goals that balance benefits and costs, and employ flexible, cost-effective methods.

I am pleased that the House Budget Committee shares the Administration's concern with a low national saving rate. The low national saving rate is a matter of great concern to the Administration. Businesses, households, and governments in the United States all save at lower rates than their counterparts in other advanced economies. Current Federal Government tax, spending, and regulatory policies are heavily biased against saving and investment.

The single most important step to raising national saving and investment is implementation of the President's proposals to reduce the Federal budget deficit to zero by fiscal year 1993 and to reduce the national debt thereafter. The reduction in capital gains tax rates and the establishment of the new Family Savings Accounts are also important means of raising national saving and investment.

Although there is active academic research and debate, empirical studies on balance suggest that saving increases with higher rates of return. Moreover, there is strong evidence that the enormous amounts that went into IRAs in the mid-80s did not simply represent churning of existing assets. The Family Savings Accounts would represent an even more attractive savings plan, especially for young families with saving goals other than retirement. In my professional judgement, reducing capital gains tax rates and creating Family Savings Accounts will raise national saving and capital formation, and therefore increase economic growth. Lower capital gains tax rates will also encourage the entrepreneurial activity which is vital to economic growth.

Eastern Europe

In 1989, we witnessed a revolution toward democracy and market reform in the centrally planned economies of Eastern Europe. The developments are of tremendous significance, holding out the promise of increased freedom and higher living standards for the citizens of these countries. However, important steps taken to date are still first steps. A difficult road lies ahead for each country as it works to bring the seeds of democracy and economic prosperity to fruition. Also, we must remember that the countries of Eastern Europe are diverse, although some of the problems they face in common. These economies typically are much poorer than the developed industrial nations. For example, by one commonly used measure, Poland has a per capita GNP only one-tenth of that in the United States (alternative methods of estimation yield slightly higher estimates). Poland has already begun to implement a comprehensive and ambitious economic plan which embraces many of the principles of free markets. Most of the others have yet to design their economic policies.

The United States, together with other countries, can continue to play a vital role in assisting the countries of Eastern Europe which undertake market-oriented reforms. Our response must continue to be both well informed and far sighted so as to act on an effective case-by-case basis to the difficult challenges each country faces. Inappropriate assistance may impede the effectiveness of market-oriented reforms.

While each centrally planned economy is unique, all have some basic characteristics which distinguish them fundamentally from market economies like the United States. Central authorities, not private citizens, own and control most of the factories and other means of production. Many of the resources, including the labor force, fertile land and office space, are allocated according to a central plan in an attempt to produce the goods that central planners think are important. In this environment, there is little incentive or even opportunity to make that better mousetrap, to look for a new job that really uses ones skills. Many of these countries developed large trade and current account deficits, financed by external debt. Many also have massive government budget deficits, typically financed by rapid money creation, which have led to rapid inflation of over 50 percent per month in Poland and Yugoslavia, for example.

The problems are complex and pervasive. They cannot be solved by quick fixes or band-aids and there is no simple blueprint which guarantees success. History does offer some helpful examples of reform. Israel and Bolivia brought down very high rates of inflation in the 1980s. The 1948 Erhard reforms in West Germany eliminated price controls and reestablished a vibrant private sector after several years of administered price controls. These reforms also stabilized the value of the West German currency and revived its usage in international markets. But there are no example where, after four decades of central planning, an economy has successfully accomplished all of these reforms at once.

We as well as the citizens of these countries must be ambitious but realistic. To be successful in reviving growth and raising living standards, economic reform must be comprehensive. However, the adjustment period may be difficult, involving large amounts of temporary unemployment. Furthermore, even a successful program will not erase the effects of four decades of central planning overnight. Many reforms will take hold only over a number of years.

Poland has embarked on an ambitious reform program. Their program was designed in conjunction with the International Monetary Fund, and after consultations with specialists from around the world, including the Presidential Mission late last year. The United States and other countries have provided financial and technical assistance, including food aid and a contribution to a currency stabilization fund to bolster confidence in the program.

While it is too early to fully assess Poland's economic plan, and few data are yet available, there are many encouraging signs. In particular, the currency reform--which devalued the zloty and made foreign exchange available for most international trade transactions--thus far appears to have been successful. There has been no run on official reserves of dollars and other foreign currencies, which some observers feared. The Poles have made no requests to draw on the currency stabilization fund, which is performing as a boost to confidence, as envisaged. Preliminary information suggests that inflation is evolving as projected.

However, it is taking time to dismantle the old system of centrally allocated goods and services, and to replace it with a new system in which producers compete in markets to supply the goods and services that consumers demand. Wheat is an important example. Although retail prices of bread and other goods have risen substantially, farmers have not been selling wheat to mills, apparently because the higher prices do not appear to have filtered down to them. Consequently, the Poles have recently requested additional wheat aid -- a request that is now begin considered.

There are groups in many agencies of the government examining the difficult problems of Eastern Europe. I will be helping, as part of the Administration coordinating team to see that our assistance is delivered in the most effective manner possible.

Mr. Chairman, I would now be happy to answer any further questions you or the members of your Committee may have.

Table 1

COUNCIL OF ECONOMIC ADVISERS

Administration Near-Term Outlook
January 29, 1990

(Calendar Years)

	1990	1991
	(Percent Change, 4th Quarter to 4th Quarter)	
Real GNP Ex-Drought*	2.6	3.3
GNP Implicit Price Deflator	4.2	4.1
Consumer Price Index (CPI-W)	4.1	4.0
	(Annual Average)	
Unemployment Rate (Total)	5.4	5.3
3-Month Treasury Bill Rate	6.7	5.4
10-Year Treasury Note Rate	7.7	6.8

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* Excludes the one-time rebound in real GNP in 1989 from the effects of the previous year's drought. The recovery of farm output to more normal levels raised growth in 1989 by approximately 1/2 percentage point.

Table 2

COUNCIL OF ECONOMIC ADVISERS

Administration Economic Projections
January 29, 1990

(Calendar Years)

	1990	1991	1992	1993	1994	1995
	(Percent Change, 4th Quarter to 4th Quarter)					
Real GNP Ex-Drought*	2.6	3.3	3.2	3.1	3.0	3.0
GNP Implicit Price Deflator	4.2	4.1	3.8	3.5	3.2	2.9
Consumer Price Index (CPI-W)	4.1	4.0	3.8	3.5	3.2	2.9
	(Annual Average)					
Unemployment Rate (Total)	5.4	5.3	5.2	5.1	5.0	5.0
3-Month Treasury Bill Rate	6.7	5.4	5.3	5.0	4.7	4.4
10-Year Treasury Note Rate	7.7	6.8	6.3	6.0	5.7	5.4

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* Excludes the one-time rebound in real GNP in 1989 from the effects of the previous year's drought. The recovery of farm output to more normal levels raised growth in 1989 by approximately 1/2 percentage point.

Table 3

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Administration Forecast Accuracy For 1989[1]

	Forecast[2]	Actual
Real GNP	2.9	2.9
Unemployment Rate	5.2	5.2
10-Year Treasury Notes	8.5	8.5
3-Month Treasury Bills	8.0	8.1
Consumer Price Index	5.0	4.8
GNP Deflator	4.5	4.1

1 Administration forecast prepared for the July 1989 Mid-session Review.

2 Data for real GNP and prices are percent change year-over-year. Data for interest and total unemployment rates are annual averages.

Table 4

Comparison of 52 Private "Blue Chip" Forecasts Made in July With Administration Mid-Session Forecast for 1989

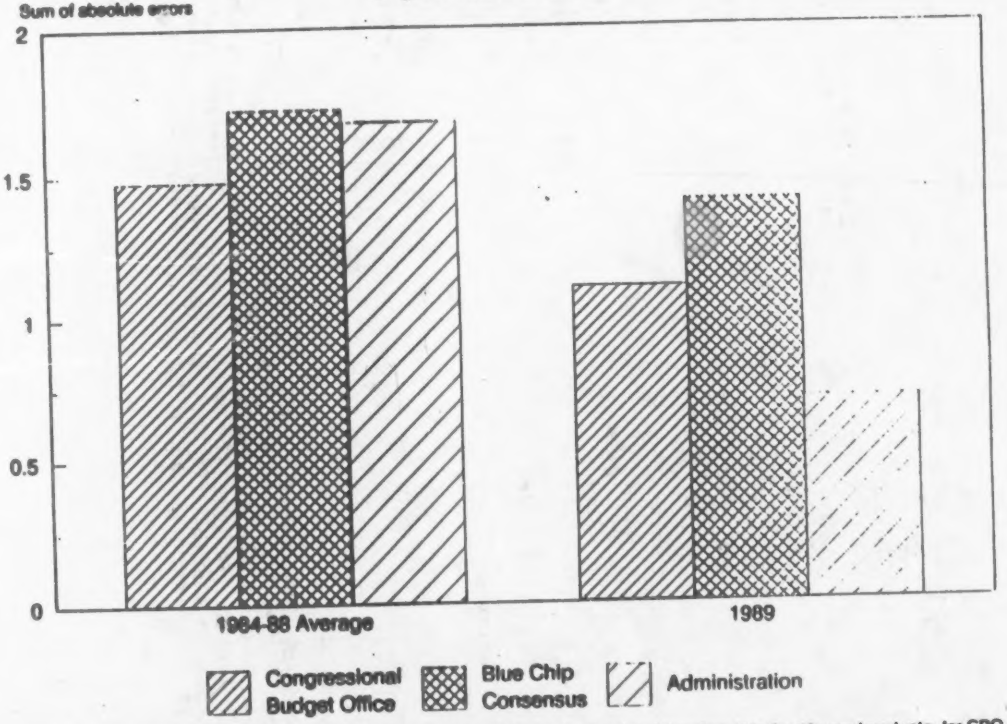
	Number of Private Forecasts which were ____ than Administration Forecast:		
	More Accurate	As Accurate	Less Accurate
Real GNP	0	5	47
Unemployment Rate	0	15	37
Long-term Interest Rate	0	11	35
3-Month Treasury Bills	6	18	25
Consumer Price Index	6	7	39
GNP Deflator	8	7	37
Combination	0	0	52

Accuracy is defined as the smallest absolute deviation from the actual figures for 1989. The combination category is the sum of the absolute deviations on all six categories. Data are for real GNP growth (Yr/Yr), the change in the GNP deflator (Yr/Yr), the change in the CPI (Yr/Yr), the unemployment rate, the 3-month T-bill interest rate, and a long-term interest rate.

Figure 1

COMPARISON OF FORECAST ACCURACY: ADMINISTRATION, BLUE CHIP CONSENSUS, AND CBO

Sum of absolute errors for real GNP growth (Yr/Yr), the change in the GNP deflator (Yr/Yr), the change in the CPI (Yr/Yr), the unemployment rate, the 3-month T-bill interest rate, and a long-term interest rate



Note: Long-term interest rate for Blue Chip is the corporate AAA bond; for the Administration, it is the 10-year bond rate; for CBO, it is the corporate AAA in 1984-85, and the 10-year bond rate in 1986-89.

Chairman **Sasser**. On the question of the economic assumptions, I want to congratulate you on the accuracy of your midterm revision last year. That was a remarkable performance. Now in looking at your predictions for fiscal year 1991, I note that you are predicting 3-month Treasury bills to be at 5.4 percent interest rate. Do you think that your midterm reassessment in July will also have these interest rates at 5.4 percent?

Dr. **Boskin**. Well, Senator, I understand you are concerned about that. Let me just reiterate that these are conditional upon the adoption of the President's policies or their economic equivalent: reducing the Federal Government's current and expected future drain on financial markets as envisioned in meeting the Gramm-Rudman targets, having a commitment to reduce the national debt after 1993 and so on, as well as the saving and economic growth issues and so on. Were it to appear that those were not likely to occur, my view is financial markets would not move as favorably. Let me also repeat that when we look at this sort of a decline, it is clear that in previous episodes we have seen very similar declines.

For example, this exact same sort of a pattern happened in 1986–87 when interest rates dropped down to 5.4 percent. So I think that while interest rates clearly are somewhat higher than that, this is really going back to economic events—and 1987, by the way, was the year we had 5.4 percent real growth—it is going back to kind of a fiscal climate where we are going to be responsible and rededicated to long-term serious reduction of the deficit and its elimination, and in this case moving toward budget surpluses and reducing the national debt.

Chairman **Sasser**. Well, I am a little confused here and perhaps you can explain it, your real growth in GNP is at 3.2 percent for 1991, which is fairly substantial growth, and while you project this substantial growth in the economy, you simultaniously predict a downward slope in interest rates. And it has been our historical experience over the past few decades that as you get growth, particularly with a seasoned inflation fighter like Alan Greenspan and the Fed, you get higher interest rates. Would this not be a rather marked departure from recent economic history to have substantial economic growth while at the same time have sharply falling interest rates?

Dr. **Boskin**. No, Senator. The exact same thing happened just a few years ago. As I recall, 1985 3-month T-bills were 7.5 percent; 1986 they started to fall; and 1987 was one of the most rapid growth years we have had, and they fell to their lowest level in some time. There was a lot of talk at that time. Over this period we had Gramm-Rudman and Gramm-Rudman II, Gramm-Rudman-Hollings, and Gramm-Rudman-Hollings II. We had various efforts to improve fiscal discipline. So I would say that we have not only had this historically, but one of many reasons why this occurred was precisely the kind of fiscal discipline that we are proposing and that we are conditioning our forecast on in this budget.

Chairman **Sasser**. Well, did not Dr. Greenspan just indicate, I think before Senator Riegle's committee or maybe the Joint Economic Committee the other day, that he thought we had had the recession specter defeated, and that the markets interpreted that as no more easing, as I recall it?

Dr. **Boskin**. I would make two distinctions, Mr. Chairman. One is between what the Fed may or may not do without any substantial reduction in the deficit, but as Secretary Brady and I have both said, we would give them a lot more elbow room if we make a serious commitment to reducing the deficit, do it as rapidly as possible and make a serious commitment to moving toward actually reducing the national debt. Our proposals will reduce the deficit, both in dollar terms and as a share of GNP.

Chairman **Sasser**. Well, I am glad you brought up the national debt. Now yesterday or last evening the President took some advice from the former Senator from Vermont, now deceased, who advised during the Vietnam war that what we ought to do is just declare victory and come home. I got the impression last night that the President was declaring victory over the deficit, and that was the end of it. Now looking here at the rate of increase in the national debt, which I think is the true measure of the fiscal health of the U.S. Government, I note that it is predicted that in fiscal year 1991 the national debt will increase by $278 billion. As a matter of fact, looking at the numbers here, there will be an increase from 1989 to 1990 of $265 billion; from 1990 to 1991 of $272 billion; and from 1991 to 1992 of $278 billion.

So when we talk about the deficit what we are talking about is a deficit for Gramm-Rudman-Hollings' purposes. We are not talking about the national debt, and when you add into this deficit for Gramm-Rudman-Hollings' purposes, the Social Security Fund from which we are borrowing and building up a liability, and you add on the off-budget liability of the savings and loan bailout and other off-budget liabilities, we are actually increasing the liabilities of the Federal Government very substantially above these numbers that we have been bantering around here this morning. Is that not an accurate statement?

Dr. **Boskin**. Well, Senator, I would respectfully demur. Part of it I would agree with, and part of it I would not agree with. Usually when you think about the liabilities of the government, you look at the debt held by the public rather than intergovernmental debt, for example, the social security accruing assets. And economists would, all economists would tell you that the best measure of the impact of the budget stance on the economy and the pressure on financial markets is best measured by the stance of the consolidated budget deficit or surplus, not by any part of it.

Chairman **Sasser**. We are talking about the liabilities of the government now, though, Dr. Boskin.

Dr. **Boskin**. If I may finish, sir.

Chairman **Sasser**. Yes, go ahead.

Dr. **Boskin**. So in this regard, I think the facts are that the debt held by the public has stabilized, and indeed, if we, if the government, if the administration and the Congress, are able to make progress along the Gramm-Rudman targets, we will see a rather rapid reduction in the debt held by the public as a share of GNP. It is correct, as Secretary Brady pointed out, that there is a social security surplus. It is becoming sizable, and that is why we believe that it is desirable to extend the balanced budget and Gramm-Rudman to include the nonsocial security part of the budget beyond 1993 and to reduce the national debt thereafter.

Chairman **Sasser**. Well, I may want to return to that in just a moment, and we could talk about that for some time and probably will. Now, Mr. Secretary, something that I have been concerned about for some time, and I know you have, too, is the ongoing bailout of the Savings and Loan Deposit Insurance Fund. As we know, last year the Congress and the administration acted together to begin an effort to remedy the problem and enacted, I thought, some very substantial legislation under the leadership of Chairman Riegle of the Senate Banking Committee and also under your leadership as Secretary of the Treasury.

Now by all accounts, what I am reading, the whole process is going very slowly. And very few of the insolvent thrifts have been resolved, and I think there is one thing that this whole problem has taught me, and that is that delay simply increases the cost of the eventual solution. I suppose what I am concerned about as a budgeteer is, does the delay that we have experienced so far mean that the cost of this bailout is going to be more than the $166 billion it is now projected to cost over the next 10 years? Can you shed some light on that for us this morning?

Secretary **Brady**. Sure, Senator Sasser. Let me first answer your concern about delay. You will recall that we passed this legislation in August 1989. We now are looking backwards at the passing of that bill from 6 months later. We have created in the RTC a corporation, a financial corporation, I think in 6 months, regrettably to some extent, which is now second only to the Citicorp in size. So it is enormous. I think it currently has to resolve institutions into about $136 billion in assets. It is an enormous undertaking in terms of pure numbers. It is also an enormous undertaking in terms of people. And I think that putting such an organization online and operating it is going to take some time. In the initial stages of the program I can understand fully everybody's worry that we are not going fast enough.

With regard to what another part of what your question was aimed at, the money, in my opinion we have had sufficient money available to the RTC during the 6 months that it has been in operation to do whatever it wanted to do. You also asked a question about the amount of money needed. I think that in spite of the fact that pundits are reestimating the size of the hole or the amount of money that we need to pay off depositors, I do not know exactly what basis they are doing this. It is very easy, of course, to overestimate the size so that at some point in the future you can say you knew it all and were right, and if it were smaller than that that you did better. But I do not know what more we would do if the amount of money allocated could actually be bigger now. There would not be anything that we could do because we are operating at capacity.

If we get a working capital financing in place, we do not need more money at this time. The pace of resolutions is going as fast as we can credibly make them go. In the future it may be somewhat faster. It also may be if real estate markets and interest rates come down that it is somewhat less. I do not think anybody knows the answer to that question. Frankly, I understand the reason for your question. I do not know what we would do differently if we knew that the total cost was bigger. I think what we need is more elbow grease and hard work, and we are going to try to do that.

Chairman **Sasser**. Well, Bill Seidman, the head of the FDIC, indicated the other day it may take another $24 billion to resolve some 225 to 300 problem institutions that are now expected to slide into insolvency. Would you agree with that or not?

Secretary **Brady**. Not necessarily. I do not think we have sufficient information to pinpoint now what the size of the program is going to be in the future. I think our goal of $50 billion may very well be realized to keep it to that level. As I am sure you know, Senator, we also have extra funds budgeted already which will give us more money if we need it.

Chairman **Sasser**. Thank you, Mr. Secretary. Senator Domenici.

Senator **Domenici**. Thank you, Mr. Chairman. I was not here, but I assume Senator Riegle was asking the Secretary, or was it Senator Sasser inquiring about the S&L situation?

Secretary **Brady**. That is correct. It was Senator Sasser.

Senator **Domenici**. I have a general question that I think the chairman of the Banking Committee may have already asked certain witnesses, but I want to ask it of you, Mr. Secretary, and lay before you a concern that I have. Because the S&L issue has become so controversial, it appears to me that some of the input that members of Congress might get regarding the shortcomings of the major effort will get some attention. Members might be less sanguine than they would have been 4 or 5 years ago to call it to anyone's attention. And I really believe it is urgent that you and others carefully look at the implementation of the bailout bill.

I think the principal suggestions for any corrective measures are going to have to come from you all because of what I have just described, and I cannot believe that we did not do some things in that bill that are not going to work or that are counterproductive or that clearly we did not intend or that we could not do better. And I seriously urge—I do not know what the chairman thinks—but I seriously urge that you look at it. I have a couple of situations from good solid people that I believe and institutions, small ones, that I believe this bill objectively interpreted required be done away with. I am not so sure in the high priority of things that we are not overapplying some of the rules there, and frankly I am not expert at it.

I am not reluctant to send it to somebody and say what do you think, but I really believe the executive branch is going to have to do most of the sounding out. Mr. Secretary, from where you sit to where they are out there in the field doing the work is a long way. And I know you want to know what is going on, but I believe this is one that you really have to have some people out there making sure that it is being managed right. There are not suggestions that are relevant to corrective measures because of the way the bill, a piece of legislation like this, evolves. I cannot say it any better. Do you understand what I am saying?

Secretary **Brady**. Certainly. I am sure we did not get it right the first time. I say we. We worked very closely with Senator Riegle and his committee. He has told us the same thing that you have just said. If there are imperfections in the system, let us hear about them, let us get on them, let us change them. Nobody can do it perfectly right the first time. We are 6 months into the process, and it is probably not too bad an idea to let some of the systems work for awhile, see how they work, and then change them when they need to be changed.

Senator RIEGLE. Would you yield, Senator Domenici?

Senator DOMENICI. Of course.

Senator RIEGLE. Relative to your point, we had a hearing, an oversight hearing, yesterday in the Banking Committee. The oversight board on which Treasury Secretary Brady sits—yesterday he was represented by Mr. Robson—was with us along with Mr. Seidman, and that precise set of issues was discussed at some length. And I would make just two points. One is is that we did build into the legislation by design a certain amount of flexibility in terms of policy discretion and judgment. That is why we have an oversight board that has to, in effect, craft policy, and they are doing that. And a lot of these are very hard judgment calls, as you imply.

Also, yesterday, Mr. Seidman, who is running the Resolution Trust Corporation, also said that even his thinking is changing on some issues in terms of how you try to resolve the problem in a way that does not push more institutions over the edge, where you trade a smaller problem that might be manageable for a bigger problem that is unmanageable. So I think it was fair to say from that hearing, which went on about 4 hours or so yesterday, that the administrative officials in charge of carrying out the law are right now trying to make the policy judgments and decide how best to handle this situation.

If and when there is any recommendation coming back to us that says, look, we need some structural change, then we will take a look at it. We have not had any hint of that as yet. In fact, the testimony yesterday was to the effect that they had the money needed for the foreseeable future, and that they have the policy decisionmaking process working smoothly. I asked both groups, the Oversight Board and the RTC, if there were any snags right now in terms of interfacing and settling issues. They both testified on the record that there were none, and that issues were being resolved in an orderly way.

I would just say one other thing, and I think you have put your finger on it. This is a big problem, and the Secretary himself has said this. This is an enormously complicated problem, and to get a system up and running—Senator Bond serves on the Banking Committee as does Senator Sasser so they have lived through all of the debate and construction of that program—is a terrifically difficult and complex job, and in some respects it is getting bigger. We have problem institutions out there that are going into the group that need attention.

I think it is fair to say that the people that have been put into position, and there are some positions still vacant that need to be filled, are working as hard as they can, and I think they are finding that they are working against a problem of a size that really is unprecedented in our history since the 1930's. But I think the level of cooperation has been exceptional. Whenever we have needed to sit down and try to work out any of these issues, we have been able to do it. And I certainly would welcome, Senator Domenici, any thoughts that you have, or if we reach a point where you or others want to come in and address these issues, I would welcome that. It is a big country, and there may be things going on in your part of the country that we would need to hear in that direct way.

Senator **Domenici**. Thank you very much.

Chairman **Sasser**. I think your time has expired, Senator Domenici.

Senator **Domenici**. My time expired. I did not even ask a question.

Chairman **Sasser**. Go ahead.

Senator **Domenici**. But I do appreciate the chairman of the Banking Committee's comments. Let me ask Dr. Boskin what is the single-most important thing that you think we have to do to maintain sustained growth with reasonably low inflation rates? I think that is the real program for America; I think that is the program for social security; that is the program for everything.

Dr. **Boskin**. Senator, that is a no-brainer, if you will pardon the phrase. We have to make steady, substantial continuous reductions in the budget deficit. We should be moving beyond 1993 to the Federal Government shifting from a being a chronic borrower draining away the scarce supply of private saving, inhibiting our investment and causing or being one of the major causes of our external imbalances, to have the government contribute to the supply of savings. So I think that by far and away that is the most important thing.

There are many other things we will need to do to make sure our markets are competitive and vibrant, that we invest in our human capital, and we enhance our R&D and all those other things, but the main thing we need to do is continue the progress and enhance it and redouble our efforts and to make sure not only that we do that in our view steadily year after year, but we send clear signals to the financial markets that we are going to keep our nose to the grindstone to the market and do it.

Senator **Domenici**. Well, inflation bothers me in the future, and I submit we better keep our eyes on the energy situation because it is a major contributor. As we grow more dependent on foreign producers, the more we risk outsiders having the potential for controlling this economy. The investment of the Japanese in this country pales in comparison to what countries might do because of our oil dependence. And speaking of the trade balance, I just did some numbers, and I just want to share them with you.

If we were to have our mercantile trade balance at zero and continue the current rate of importation of petroleum products, we will build up to a $100 billion trade deficit 8 years from now. That means we would go through all this effort to get the trade deficit to zero, which is probably not very feasible, and we will still build up to a trade deficit almost the size of what we have today because we are now 43 percent dependent on foreign oil, and we were only 32 percent dependent some 26 months ago. I hope you all know that we have got to do something about that. You have some energy production incentives in your budget proposal. I laud you for them.

Let me give you my second concern. I think we are doing reasonably well increasing our productivity in the industrial sector of our economy. We lament and complain, but our industrial workers are still the most productive in the world. The problem is the others are gaining on us. That is one thing, but I think the other problem is that aside from their R&D and their moving ahead in some areas, I think our service sector is among the largest in the free world. And I am not at all convinced anybody is looking seriously at how to increase the productivity of the service sector.

I just need a quick observation on your part. While you are at it, tell me why the President's family savings account costs anything in the first 7 years unless there is a shift going on between current taxable instruments and nontaxable ones.

Dr. BOSKIN. On the productivity question, I would defer at least the first part of the family savings account to see if the Treasury Secretary would like to answer that although I would be happy to depending on him.

Secretary BRADY. The revenue estimates on the family savings plan do show a loss to the Treasury in the first year of some $200 million, because some shifting does occur. Treasury revenue estimates, as JCT estimates, do not incorporate feedbacks that affect the macroeconomy. Hence, they do not include the effects of new savings, which we are sure will occur. I think in the long-run that will surely be the case, but that is not the way the estimating is done in Washington.

Senator DOMENICI. How about social——

Dr. BOSKIN. I would just add that to assist our colleagues at the Treasury, the Council did some rough analysis just to see how little the increase in saving would have to be to make sure that we did not run into the problem of the small revenue losses not being offset by more saving. And you really need only a very small saving response, much smaller than would be the case in comparing them to what other saving vehicles have done and the typical academic research would predict. So we are confident that they will generate more savings than the revenue they will lose to the Treasury, and that obviously there will be growth effects, and as the Secretary has said, dynamic effects on revenue.

On the productivity side, let me just say that we are concerned about productivity growth in the service sector. We are also concerned about better measuring it. One big problem that we have is that there are large parts of the service sector where we have virtually no measures of productivity. Sometimes that occurs because it is hard to measure output. If you are measuring tons of steel that is pretty easy to count. If you are measuring computer software programs you cannot just add Lotus I, II, III and Word Perfect and say that is two software programs. In some sectors, for example, in health care, what goes on in a given day in a hospital is very different today than what went on many years ago and in other sectors, and we do not account for that quality change very well.

Other sectors we measure the output by the cost of inputs. The President has committed us to a program to try to improve the measurement of our service sector productivity. There is a proposal in the budget that includes some funding to begin that work, in the BLS and the Commerce Department and elsewhere. I chair an interagency working group that is trying to press in this direction. You are quite correct that service sector productivity in any event is not dramatic productivity growth. Our first step is to really understand it, and we are working hard to do that. But you are quite correct. The services producing sector is quite large in the United

States, and we need to improve service sector productivity, and we also need to make sure that when we get the productivity it shows up as increased output, not as just mismeasured.

Chairman SASSER. Thank you, Senator Domenici. Senator Robb.

Senator ROBB. Thank you, Mr. Chairman. I would like to follow up, if I may, on a question that you initiated, but I am not quite certain that I got an explanation. Mr. Secretary, or Mr. Chairman, let me from the President's speech last night read just a very short portion. He says we are getting our own house in order. We have made real progress. Seven years ago when we made that comparison that we have talked about here, and we know how the figures work. That brings the Federal spending under control. It meets the Gramm-Rudman target, brings the deficit down further, and balances the budget by 1993 with no new taxes.

And then he goes on to say, and once the budget is balanced we can operate the way every family must when it has bills to pay. We will not leave it to our children and grandchildren. We will start paying off the national debt. Now it seems to me that we can go through what those of us who are concerned about the real deficit believe is a subterfuge or however you want to describe the deception of calling the Gramm-Rudman deficit something other than the actual increase in the national debt from year to year.

But the clear implication is that 1993 arrives. We accept that definition of the deficit, that it is now gone, but when you start talking about paying off the national debt, you cannot use that same kind of definitional charade to get to that particular point. Is the President suggesting that he is going to start paying off everything that makes up the amount of the Trust Fund surpluses in addition to making progress over and beyond the national debt, or how are we to interpret this?

Secretary BRADY. Senator Robb, let me take a crack at it, and then if Mike wants to amplify it, ask him to do so. I cannot remember the exact line in the speech, but I think he was referring to the fact that after 1993 when the Gramm-Rudman targets, at least, get to zero that the suggestion is that a new fund start to take place which in the first year actually operates in effect as a sinking fund and buys back $16 billion of the national debt. So when the Gramm-Rudman targets reach zero, this fund starts to operate, and I think that is what he was referring to.

Senator ROBB. I think I am interpreting it the same way, but the question I am asking is how can we ignore the fact that the national debt is continuing? In other words, this year we increased it up to $3.12 trillion, whatever it is, and we are clearly going to have to increase the national debt in each of these years through 1993 and beyond even on the projections that obviously we would all like to see come true, whether or not we regard them as optimistic or not.

But it seems to me that we begin to believe our own charade if we then accept the fact that we really have eliminated any increase in the national debt, and we are starting to reducing it. My definition of the national debt is starting to be paid off means the national debt starts to go down. I just do not know how we can square that with the rhetoric here, and I just want to make sure I understand because I——

Secretary **Brady**. I do not want to get too simplistic, but this sinking fund, or mechanically it does not quite operate that way, would be a purchase of debt outstanding. It does not mean that there might not be additions at the same time, but I do not think——

Senator **Robb**. Well, I guess that is the point. Is that the way we want to represent that to the American people? I mean is that honest?

Dr. **Boskin**. At that time, Senator, the total national debt will start to decline inclusive of the issue you raise. It is estimated that in 1993 we will be in a small unified budget surplus. The social security surplus being some component, some substantial amount. It is estimated to be—I do not have the exact number—$80 billion. The rest of the government would have a $70 billion or $64 billion deficit, and we would have a $16 billion surplus or something. Beyond that year, starting that year and beyond that year, we would be having a balanced budget requirement for the nonsocial—we would phase it in over 3 years—but the nonsocial security part of the budget would be balanced. The social security surpluses would be protected.

They would not be spent. They would be used to purchase Treasury securities so that those reserves will be there. And what you are calling the national debt inclusive of not just the debt held by the public, but inclusive of the surpluses in social security will stop, will stabilize, and the publicly held debt will decline rapidly.

Senator **Robb**. Well, maybe the question I should ask is this. After 1993, assuming all of the factor that have been included in both your economic assumptions as well as the projections on the deficit, can we forever—and I realize that is a little bit naive—but if everything worked the way you say it is going to work, would we never have to increase the debt ceiling again, debt limitation? I mean that is the common sense interpretation, and it does not seem to me it squares with what you are saying?

Dr. **Boskin**. Assuming things went this way and at least in that intervening period there were not short-term perturbations around that, yes.

Senator **Robb**. Thank you, Mr. Chairman.

Chairman **Sasser**. Yes. Well, I am somewhat mystified myself, Senator Robb. Senator Bond.

Dr. **Boskin**. Yes and no answers are not very clear.

Senator **Bond**. Thank you, Mr. Chairman. Secretary Brady, what is your assessment of how well the administration's Third World debt program is working?

Secretary **Brady**. Senator Bond, I am very pleased with the progress we have made in the attempts to alleviate the Third World debt problem. We will, on this coming Sunday, sign the deal with Mexico. Shortly thereafter in mid-February, we will sign with the Philippines part of their debt reduction transaction. Followed by that, we have another closing which should occur in the first quarter with Costa Rica. So I think that a pattern is beginning to emerge whereby we can deal with these problems. We, of course, have enormous goals before us. Our objectives this year are to deal with, hopefully successfully, two of the larger problems, Venezuela and Brazil, and I think that, again starting from scratch this last year we now have some of the machinery working rather smoothly so that we do not have to reinvent the wheel every time we do one of these transactions. So I am pleased.

Senator Bond. In Latin America and in the banking community, there seems to be some hope that the taxpayer's wallet in the United States is going to be used to soften the blow and to ease that transaction. Would you care to comment on that prospect?

Secretary **Brady**. Well, one of the goals of this new debt strategy is to try and make sure that that does not happen. I know some of the leaders in Latin America and elsewhere around the world where large debtors exist that every time they see the President of the United States they express that hope to him. But that is not our goal. Our goal is to do again what we have done in Mexico, to try and use the international institutions and the help and cooperation of the commercial banks to produce a program that these countries individually can adopt and still conduct economics in their own country in a way that will help their own standard of living.

Senator Bond. A question that our ranking member asked me to pose, I suppose first to Mr. Boskin and then Mr. Secretary, if you have a comment. What kind of monetary policy response is the administration assuming in its economic forecast? And, do you expect the Federal Reserve to go along with it? In addition I have my own question. Is not the monetary policy, particularly in long-term, really being set by the marketplace rather than by the Fed with the extent of debt in foreign hands? While the Fed can make some impact on the short-term debt, is this monetary policy not more determined by the international marketplace and my suggestion would be that our action on fiscal policy may have a greater impact on long-term interest rates than the Federal Reserve may have through its monetary policy?

Secretary **Brady**. Well, I think the answer—your statement of the situation is accurate. Perhaps you have to separate it into two parts, and with respect to long-term interest rates, the great preponderance of forces in effect on those that affect those interest rates are done by markets. What people feel about inflation? What people feel about the safety of their investment? Supply of debt on hand.

However, in the short end of the market, certainly the Federal Reserve System has an effect, and you are quite correct that if we in the executive branch, and I include in that the Congress in the sense that we are all responsible for fiscal policy, if we in that side of the operation would give the Fed some relief on the fiscal front, they would be able to operate in a less restrictive manner with regard to monetary policy. So said simply, if we continue to move the deficit down, I think you give the Fed more room to move interest rates down in the short range.

Dr. **Boskin**. And that is what is assumed in our forecast.

Senator **Bond**. Mr. Boskin, you glanced off the point of what might happen if a significantly more burdensome and restrictive Clean Air Act than that proposed by the administration were to be adopted. Suggesting, for example, that something like the Senate committee plan were adopted, what is known about it today, do you have any change in the forecast or any prognostication as to the impact on growth, on inflation, and on unemployment?

Dr. BOSKIN. Senator, let me take that in two parts. By talking about what was in the forecast and what was not, I meant to use that as one example of a generic issue. But with respect to the specific impact of a more restrictive Clean Air Act. I am in charge of an interagency group where we are trying to monitor the cost of these things in compliance with the President's request about what sort of legislation he may or may not be prepared to sign. And in doing so, the preliminary estimates of the Senate bill, which is moving a little bit, I understand, but the preliminary estimates of the Senate bill had cost more than double those of the proposals the President had sent up which already had substantial economic costs to achieve major economic gains where the Senate's bill had only trivial additional environmental improvements and removing all the flexibility.

Senator BOND. What would be the impact on the——

Dr. BOSKIN. So I cannot tell you exactly what would be on the forecast. I can tell you that it is very likely that those additional costs would cause some disruption to the economy. They would cause higher prices for ratepayers for their utilities. It would probably cause some disruption in some sectors of our economy, and at least some, temporary unemployment and so on. Those costs will come out of people's pocketbooks, out of jobs, and out of the prices they pay for their goods. And I think that it is important that we balance those benefits and the costs. The President has a very, very carefully balanced environmentally aggressive clean air proposal that built into it some flexibility mechanisms to try to keep the hit to the economy under control.

Senator BOND. I would welcome the chance to pursue that investigation with you at a later date.

Dr. BOSKIN. Yes, sir.

Senator BOND. Thank you, Mr. Chairman.

Dr. BOSKIN. Yes, Senator.

Chairman SASSER. Thank you, Senator Bond. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman. Gentlemen, thank you very much for being here. Mr. Boskin, I was out at Stanford this last weekend inaugurating a new program at the business school, and we had a very spirited faculty seminar, and you were grievously missed in that. You were quoted a lot and by everybody from all kinds of different perspectives.

Dr. BOSKIN. Thank you.

Senator WIRTH. Let me ask you about the budget, if I might, Michael. Two days ago there was a great deal of controversy in front of the House Budget Committee which I am sure you saw reported on television on Tuesday night. We had Mr. Darman in front of the Budget Committee yesterday, and he said that it was his opinion that we ought to be trying to take bigger steps rather than little steps or sideways steps. I asked him and I think we agreed, that the two biggest areas of controversy are the size and scope of the debt, and he agreed that this year the United States Government is going to borrow about $300 billion and that this difference between our default and debt is one fundamental problem and perhaps area of disagreement, and the second was over defense spending; that there are many here who believe that our path of defense cuts ought to be more aggressive.

We agreed that those were two of the touchstones of the budget controversy or the two biggest ones. A third one being the usual debate over economic assumptions, which we can all have ad infinitum, and get thoroughly buried in it. What would you define as the ingredients of bigger steps? If we were to take bigger steps on those two controversial areas, or the two areas that seem to be the ones of greatest disagreement between many people in the Congress and the administration over the budget, what would you say ought to be in these bigger steps, and how might we go about getting to a place where we could take bigger steps?

Let me just preface that also by saying that I opened my comments with Mr. Darman, as I would to you, saying there are a number of things in the budget that I think are really terrific. The environmental initiatives I think are first rate. I think that the goals being set in education make a great deal of sense. The science and technology steps are absolutely what the country needs. So as a background to say I am not one of those waving and throwing bombs, but rather would say I am looking for how might we find some way of resolving, if we can, those other two major issues?

Dr. **Boskin**. Well, let me first say, Senator, thank you for the kind words about the budget, and you mentioned two areas, debt and defense. And I am not on the defense side of the house, but it is my own view as a citizen, it is my own feeling that we have to make sure that we have a prudent national security policy.

Senator **Wirth**. Nobody disagrees with that.

Dr. **Boskin**. After careful analysis of recent events, the President has proposed reducing defense outlays by about $30 billion over the next 3 years from what he proposed last year and budget authority by $64 billion, and larger amounts in further years and declines in defense continuously for 5 years. Now again I preface this by saying I am not a defense expert, but looking around the world, there is still a lot of uncertainty.

Senator **Wirth**. Well, those declining factors are smaller than they have been over the last 5 years. That is what——

Dr. **Boskin**. We have to be somewhat realistic about that. With respect——

Senator Wirth. Let us leave aside all of those kind of positions. If, in fact, we all know—the President last night came in with an announcement of a 100,000 troop cut. That is going to be a significant saving. Mr. Cheney has on the docket a whole variety of weapon systems that are undergoing analysis including new aircraft and various deployment of ships. We all know that that is the case.

Dr. **Boskin**. Let me give you my best answer.

Senator **Wirth**. How do we do this? That is the question.

Dr. **Boskin**. Let me give you my best answer in defense. Since I do not think it is my place, since I am not an expert to talk about specifics, but I think that one of the single biggest improvements that could be made, one that every defense secretary of the last several administrations has suggested once we have some idea of how things are going to settle down—I realize things are changing rapidly—is to try to get some more consistency and some more certainty in defense budget planning. They have all said they could do with less if they were certain they would get it so they were not always cutting production runs in a given year when the budget changed and so on.

And that leads me into my second point that the beneficial effects of the substantial reduction in the budget deficit and the stabilization and reduction of the debt held by the public that is proposed in the President's budget over the next several years would be reinforced substantially if not only this was done step by step or year by year, if it were possible to have a credible multiyear commitment to achieving that. And I realize that the Congress legislates and the President proposes and either approves or disapproves. So if you want a generic answer, I think the beneficial effects of reducing the deficit in financial markets would be to decrease interest rates and help stimulate the economy. It would be reinforced if things could be done on a longer run basis than just year by year if that is possible.

Senator WIRTH. You do not disagree that we are going to be borrowing this year about $300 billion, a little more than that?

Dr. BOSKIN. It would depend on what you would include in those costs. There are many components and some of them are sort of like adding apples and oranges, others apples and tangerines. Not all of them are apples.

Senator WIRTH. But we are going to be. I mean that is what Darman said yesterday.

Dr. BOSKIN. Yes.

Senator WIRTH. That is what the Budget Committee analysis suggested that we are, despite the numbers that are thrown around in Gramm-Rudman, we are going to be borrowing this year about $300 billion. And that is where the area of, I think, the greatest debate and unhappiness up here is. If you can, with all the caveats on defense, and even saying we have to negotiate this with the Soviets and all of that sort of thing, it seems to me it is pretty clear that we are going to see further reductions in defense. And that gets put on the table as part of these bigger steps. You know that may become part of dropping the $300 billion down.

What I think the greater concern up here is is that this debt continues to grow while the deficit drops; it cannot be covered over by saying it is somehow a Gramm-Rudman target. It is not. There are all of these other items that we are borrowing money to meet our obligations. You know the bailout of the S&L industry being another. We have to borrow that money from someplace. Just because it is not on the budget does not mean that we do not have to go to the markets and borrow the money.

Dr. BOSKIN. Well, let me just add that a substantial portion of that involves debt that will not be held by public, and so the pressure on financial markets, I think, is not accurately measured by the $300 billion. It would be considerably less than that. But when you add the social security surpluses and so on, and take a consolidated position for the Federal Government's borrowing needs, it would be considerably less.

But your generic concern that we are borrowing way too much, that we are adding way too much to the national debt, and we need to decrease that rapidly, I share that concern.

Senator **Wirth**. Then the question is how to get at that? That I think is the core of the greatest frustration here, and what steps can we take that are bigger than the ones here? That is the fundamental problem in what is going to be a confrontation if we do not figure out something to do about that between the Congress and the administration.

Dr. **Boskin**. I would just add one word of perspective if I might, Senator, which is that it is very important that whatever is done to do that that we adopt a somewhat broader view than a simple accounting convention that looks at outlays and receipts and then figures that any move in any of the components of either side of that will automatically reduce the deficit by that amount.

We have to really look at what is going to help the growth of the economy, and I would distinguish various types of spending and so on in that regard. And what we can do to make the economy grow more will mean that we will get more revenues in that will have a higher income and the cost of servicing will be easier and so forth. So I would just put in that broader perspective as well. I think we should not be so shortsighted that we try to take purely accounting view and do something that harms the growth of the economy in the process.

Senator **Wirth**. Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Wirth. Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman. Welcome, Mr. Secretary and Mr. Boskin. I said yesterday to Richard Darman that I read with great interest his preamble to the budget, which I saw as a clarion call for action to slay the deficit dragon and then I looked to the battle plan in the budget, and what I saw was orders from the Commander-in-Chief to stay in the barracks. And I just want to express my own frustration. I think frankly that the President and those of you who advise him on these issues are guilty of a leadership failure of significant proportion.

And my own view is that we are finding ourselves in a weakening position internationally, and we do not seem to be able to summon the political courage or the political will to fashion a game plan that really has much merit. And it really worries me about the future. I noticed in the New York Times several days ago a big story: interest rate rise abroad forcing the United States to join in, too. Indications in that same paper that day that the U.S. deficit was up in the months . . . "Federal budget deficit increased $14.6 billion in December bringing the deficit total so far this fiscal year to more than two-thirds the amount permitted for the entire year."

I looked at the forecasts. Yesterday we had a number of economists in, at the Deficit Reduction Caucus—a group that meets every 2 weeks, and we cannot find anybody that buys these forecasts of growth, Michael. They think they just are not in touch with the reality that we confront. Can you give us some view if you were going to do it today, would you still hold to those numbers? And what are you going to do when we get the snapshot in July, and all of this is shown to not hold water? What are we going to do then?

Dr. **Boskin**. I think it is important to recognize, Senator, let me just say that the President, Secretary and I share the concern that we make substantial deficit reduction. I do want to point out that when you make this statement that nobody is this optimistic. If you take the 52 private blue chip forecasters, around 20 or 25 percent of them are as or more optimistic than we are for this coming year, among them, the two most respected private academic forecasters. And I could go on and on so that we are well within the range that highly paid, well-regarded professional forecasters suggest.

It is also a year that is only 80 percent as robust as the entire postwar average. I would add, with all due respect to the fact that I have great professional regard and respect for the Congressional Budget Office, they have been too pessimistic every year for the last 3 years. On interest rates they have been high 8 of the last 9 years. So I think that the notion that we are always viewed as optimistic is a bit mistaken, and we were quite accurate last year. That is no guarantee we will be this year.

So given there have been some events for the last 3 or 4 weeks that have occurred, would we make any major changes in our forecast? Not on what I have seen thus far. But it will depend on what happens over the next several months. I cannot guarantee that I will not recommend changes at the midsession review. It will depend on what happens.

Senator CONRAD. Well, let me just try to, you know, what happened in the past is not much help right now. I mean what we are faced with is in the last quarter, 0.5 percent growth. In order for your projection to come home, we would have to go up to 3.3 percent. I mean all of a sudden this economy is going to go zooming. What is going to lead this economy to experience a rapid speedup all of a sudden when we have got rising interest rates in our major competitors which is putting pressure on our interest rates to go up?

Dr. BOSKIN. Well, Senator, let me just say first of all that I would not consider the growth that we are forecasting as zooming or anything of that sort.

Senator CONRAD. But when you go from 0.5 percent to 3.3 percent and have to do it in the next quarter in order to make your request, I would say that is——

Dr. BOSKIN. I am afraid either—maybe I did not state things properly. But if you look at our forecast, the 3.3 percent is for calendar year 1991.

Senator CONRAD. I know, but in order to make your whole forecast, because you were so weak in this first quarter, you got to go——

Dr. BOSKIN. These are calendar year forecasts, sir, not fiscal year. That 0.5 percent was last year, and actually to make the growth rate, the fact that it was low in the fourth quarter makes it easier because you are starting from a slightly lower base. We would have been happier with more robust growth in the fourth quarter.

Senator CONRAD. Well, are you assuming that in this first quarter we are going to see something stronger, substantially stronger than what we have?

Dr. BOSKIN. No. We believe that as the year progresses, the economy will improve throughout the year. We believe that the second half of 1990 will be stronger than the first half of 1990. The economy is in a period of slow growth right now. There is no doubt about that.

Senator CONRAD. Well, I guess the problem is it is easy to obfuscate all these things. I would just ask you what is the option? When we get to the midyear review and the number is a much bigger number than you guys have sent up here so far, what is the game plan then? Do you have an option? I mean assuming, obviously you believe you are right in the forecast. What if you are wrong, what is the option then? What are you going to tell us then?

Dr. BOSKIN. Let me just first say that whether I am right or wrong that we have always said—I have said every time I have appeared before this committee—forecasting is not an exact science. For the first time this year we are presenting in the budget alternative paths the economy might follow to give better information about how that might affect the budget outcomes, both more optimistic and less optimistic or more pessimistic scenarios rather than just a simple table about what happens if interest rates vary by a percent or something of that sort.

We will see how the economy evolves, how fiscal and other policies evolve over the next several months, and as we approach the midsession review, we will make what revisions are necessary. If indeed it looks like the total of those revisions will lead to an estimate of a higher deficit, we will have to deal with proposals to make the Gramm-Rudman-Hollings targets. On the other hand, if the economy does even better than we forecast, the reverse would be true.

So I cannot tell you what specific proposals may or may not come about as we go through the budget process or as you go through deliberations. I can assure you there is no attempt being made deliberately to overestimate things now in order to make things look worse later on. But again, the course of the economy may or may not be different. And again, if we are talking about fiscal year 1991, we would be talking about how we saw the economy in July for the period that started 3 months later and continued for the following year.

So we would have to see some evidence that would cause us to change our view about how the economy, the whole path of the evolution of the economy for the next couple of years, not any one short-term number.

Senator CONRAD. Well, I would just say to you I have talked to dozens of people who were major corporation executives, economists. They tell me without exception this thing is dead in the water, and there "ain't" no prospect anytime soon, that I have heard from any of them, that we are going to see substantial pickup. I hope the answer is not going to be to just take more stuff off budget because, you know, it seems to me we have already got that with the REFCORP situation. You know I go to people at home, and I say, well, you know, one way we are going to solve this deficit situation, I guess, according to our leaders in Washington is we are just going to move more of it off budget.

We spend it, but say we are not spending it. How do you recommend, Mr. Secretary, that we handle the working capital requirements? Are we just going to say that we are not spending that money or how is that going to work?

Secretary **Brady**. Well, let me just describe the nature of the problem. In regard to working capital, which was something that was contemplated in the original legislation and left to a later date to decide how we are going to handle it, that occurs when the RTC takes over a certain number of savings and loans, pays off the depositors, and then has a large accumulation of the assets which that savings and loan had before.

The question is, what do you do about financing that? Well, what we are suggesting, and we have not suggested a remedy to Congress because we intend to work with them to come up with one, what we are saying is you do the same thing that you do in normal corporate life. You borrow that working capital with the idea that as it pays itself off, you extinguish that debt. Every U.S. corporation that I am familiar with does that and does not adjust its income account or capital and surplus when it takes a working capital loan. It simply borrows the money against the assets. When the assets are not used any more, they are liquidated. It then pays off the loan.

Senator **Conrad**. Is not by statute the President required in his budget to indicate all items of spending?

Secretary **Brady**. Well, that is correct, and until we know the precise working capital needs, we are unable at this moment to do that. Although in the next couple of months, we are going to have to do exactly that. Let me tell you where the——

Senator **Conrad**. Is the President going to adjust the budget at that point?

Secretary **Brady**. Well, at that moment in time, you are going to have to decide whether you want to do that or not. If you want to put this on budget you will have an effect in the year that you borrow the money of a huge outlay creating a big deficit. The following year when you liquidate it, you are liable to come forward with a revenue bulge to the government that will be two or three times the size of the budget deficit.

Senator **Conrad**. If you were running an operation, if you were an accountant looking over an operation, would you allow anybody not to reflect it in their budget that they had an outlay of that magnitude?

Secretary **Brady**. Well, every U.S. corporation—I think maybe you ought to ask the Big 8 accounting firms—every U.S. corporation does it exactly that way. They do not reflect in revenues decreases or increases in working capital because it would totally throw off the picture.

Senator **Conrad**. The government accounting system, as you well know, is not a corporate accounting system.

Secretary **Brady**. Well, the same principle obtains in this particular case. I am not suggesting we do it that way.

Senator **Conrad**. Well, we do not do that other places in the Federal Government. I mean the Federal Government—we just do not operate that way. Maybe we need to change the whole system, but——

Secretary **Brady**. Well, maybe, but carrying your suggestion to operational view., if you want to put it on budget, what you are going to do is swing the deficit wildly. In the year in which you borrow the money, suppose it was $60 billion, you will increase the deficit by $60 billion, which in this particular year could take it from $60 billion to $120 billion deficit. Next year when the deficit is supposed to be $28 billion, if that $60 billion came back due to asset sales you would produce a surplus of some $32 billion. So it is a question of how you want to handle this thing.

Senator CONRAD. Yes. The problem that I see is that now we have got Mr. Seidman saying we need $24 billion more than was previously anticipated, and I am not certain that anybody can have the assurance that the outlay is going to be matched by the revenue. In the perfect world that would happen. I think those of us who have watched this S&L debacle might conclude that we might not have a match, and in that case where do you properly reflect that you have had a huge outlay and revenue may not come to match it?

Secretary BRADY. I think it is important that we distinguish between what the size of the hole is and what the working capital needs are because they are too different issues entirely.

Senator CONRAD. When might we have that estimate? Do you have any idea when that——

Secretary BRADY. Well, we are working on it now with the RTC and I would expect in the next month or so that since we are going to need that working capital, we are going to have to come to resolution with Congress as to how we are handling it. With regard to the size of the hole, I do not think anybody precisely knows what the hole is. I see no virtue, Senator—I said this before you were here—in everybody guessing at what the size of the hole or thrift losses are. One, we would not do anything differently right now if we knew it. Two, it sets up the game that we had this last year where the guy that produces the highest number is the guy that gets in the newspaper that particular day.

I do not see what that is worth frankly. We have got to do, what we should do, and that is work hard at the problem. There is no point in estimating the thing high so you can say later on that you were right. And if it is less than you said you did a good job. That does not appeal to me as the way to approach this.

Chairman SASSER. Well, I promised we would get the Secretary out of here by 12:30, and we are running over. Let me just if I might ask one quick question, Mr. Secretary. In the capital gains provision that is offered by the administration, it indicates that it will produce $4.9 billion in revenues in 1991. Now the administration is presupposing that that capital gains provision is going to be enacted into law by March 15, 1990. I do not see that happening. I mean even if it were enacted into law, I frankly do not see a revenue measure going through here and being in a posture to go through both houses, be conferenced, signed into law until sometime in September or October. What is that going to do to your revenue number there because you are just going to have maybe 1½ or 2 months to get those transactions completed so they will be credited on to 1990 for 1990 revenues?

Secretary BRADY. Well, you put your finger on an important point, Chairman Sasser. All of the revenue suggestions, of course, are dependent on being enacted. If the date of enactment changes, there may be a revenue shortfall and we will have to figure out a way to make up the shortfall.

Chairman **Sasser**. Well, it is a problem, and it is something I think we ought to take cognizance of. Let me say one thing before we adjourn. I heard from the distinguished ranking member earlier, a man for whom I have high regard and great respect, and also you, Mr. Secretary for whom I also have high regard and great respect, extol the virtue of the social security surpluses as a vehicle for our national savings. And I think I ought to say for the record what I think is precise about the realities of the budget and social security.

I think we would all agree with the statement that if the on-budget accounts were balanced, then the social security surpluses would contribute to the national savings. I do not think anybody would disagree with that. But that abstract statement, I think, ignores two realities. The first is that the social security surplus keeps us from confronting the underlying deficit in the on-budget accounts. They have masked the size of the deficit, and they have allowed us to take credit for progress against the deficit which has not occurred. We saw that last night in the President's speech in my judgment.

Now the cold hard fact is that the on-budget deficit has been stuck at $220 billion for the entire period of the Gramm-Rudman-Hollings law. And what many of us are saying is that we have got to strip away this veil of social security, and what we need to seek are positive incentives for both the Congress and the administration and the American people to reduce the on-budget deficit. I don't think these failed negative mechanisms of Gramm-Rudman are working. And this is the second reality.

I think that these surpluses are illusory. They are being used to finance the on-budget deficit through a regressive payroll tax. Senator Moynihan, I think, has rightfully called our attention to what is occurring. And pretending that it is just fine that the Social Security Fund is doing well, the surplus is there, when in fact it is coming in the front door and going out the back door. And you know the people are waking up to it. The same waitresses in Knoxville who asked me about a cut in their social security tax, they say, well, why not cut it; you fellows in Washington are spending; "ain't ya' "?

So they are on to what we are doing up here, and as I cautioned Mr. Darman yesterday, this proposal of Senator Moynihan's is a ticking time bomb, and this thing could get rolling and go through here so fast that it would take our breath away.

Well, I see we have been joined by Senator Exon, and Senator, we were just getting ready to adjourn. I promised we would get the Secretary out of here by 12:30, but we would want to refrain and see what you might have to add today.

Senator **Exon**. Mr. Chairman, thank you very much, and welcome, Mr. Brady and Mr. Boskin. I know that time is short. I apologize. I have been over at Armed Services where we have had two important witnesses over there today. I did want to come over and ask some questions.

I just wanted to thank you, Mr. Chairman, for the remarks that you just made regarding social security. I am a cosponsor of the

Moynihan bill. I am not sure that that bill is going to pass, but I echo the chairman's statements that it is certainly highlighted in a very vivid way, myself and others have been trying to say in different fashions for a long, long time. I think that if we were sincere, Mr. Chairman, what we would do is scrap the enforcement mechanism as spelled out in the Gramm-Rudman bill, and tie it instead to the budget deficit to the national deficit, which is the national debt.

And if we had that, we could scrap all the across-the-board cuts and everything or apply them to the national debt because as was brought out yesterday in my questioning of Mr. Darman, over the past 10 years in rough figures, the budget deficits in addition to the $1 trillion that we had beginning in 1980 have gone up over $2 trillion. During that same period, the annual budget deficits that everyone thinks adds on to make up the deficit has only been about $150 billion.

Therefore, that dramatizes that about a fourth of this cumulated deficits that we show are hidden from public view. I think it is time maybe that we get off the annual deficits, as important as those are, and look at the end result which is the continual build up of the national debt. That is what we pay the interest on. That is the fastest growing part of the budget, and I believe if nothing else under Senator Moynihan has focused attention on not only the public but the many people in the government on the inequity of that system. I thank you, and I thank you both for being here.

Chairman **Sasser**. Thank you, Senator Exon. Gentlemen, we may have additional questions to submit for the record, and Mr. Secretary——

Secretary **Brady**. Senator, could I just make a comment—I appreciate my good friend Senator Exon's comments on the current controversy about the Moynihan proposal, which I think does bring up for discussion important parts of our national policy. My conclusion would be entirely in the reverse, sir. I would think if we want to look at the budget deficit as we did in this year's budget, before and after the addition of the social security surplus, and say that the deficit is larger, that is a perfectly legitimate thing to say.

My conclusion would be entirely the reverse, that we ought to extend Gramm-Rudman, and make sure we liquidate that deficit if it is, in fact, larger deficit that is the right way to look at it. I cannot agree with you that when we see that the deficit is larger we ought to stop trying to reduce it. I feel just the opposite, and I would like to be recorded.

Senator **Exon**. Well, I think that has been a total—with all good due respects to my friend, the Secretary, that was not the point of my question at all. What I am suggesting is take Gramm-Rudman and change the enforcement mechanism to the time when we raise the debt ceiling limit? Would that not be a more effective mechanism than the present mechanism in Gramm-Rudman?

Secretary **Brady**. Senator Exon, I would have to look at the particulars of what that suggestion would imply, but I gather we are on the same wavelength now. If it is, in fact, true that the deficit should be looked at as being bigger, what we should look at mechanisms to make sure that we keep trying to work it down and not abandon the basic thrust of Gramm-Rudman which is to reduce the deficit and have something that makes us do that.

Senator **Exon**. Well, Mr. Secretary, the fact of the matter is Gramm-Rudman from its very beginning has been a means of projecting, projecting, reductions in deficit when they actually do not, as the chairman just pointed out. I guess what I am saying is if we think Gramm-Rudman is so wonderful and so good, then let us make the enforcement mechanism when we have to raise that national debt. I think that would do far more than what Gramm-Rudman has simply done, which is only attack projections that never seem to work out. Thank you very much.

Chairman **Sasser**. Thank you, Senator Exon. Thank you for your appearance here today, Secretary Brady, and you Dr. Boskin.

[Whereupon, at 12:50 p.m., the committee adjourned.]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 6, 1990

The Honorable James Sasser
Chairman, Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

During Secretary Brady's testimony before the Senate Budget Committee on February 1, 1990, you asked for the Treasury Department's comments on two proposals intended to address the apparent short term outlook of American business. You also requested more detailed information regarding the revenue estimate for the President's capital gains proposal. Enclosed are materials responding to both of your questions.

The first enclosure (labeled Exhibit 1) provides our comments on the two proposals relating to the apparent short term outlook of American business. The second enclosure (labeled Table 2) is a "breakout table" which illustrates the various aspects of the revenue estimate of the President's capital gains proposal.

You had also requested that we prepare estimates of the 10-year revenue effects of the President's capital gains proposal. To do so accurately would require a 10-year projection of the baseline macroeconomic forecast of the U.S. economy. However, those projections are only made for 5 years, through 1995. Any extrapolation of the baseline beyond 1995 would require either a purely mechanical extension or an independent forecast of such trends. Either approach would be arbitrary and could well result in the use of economic assumptions inconsistent with those underlying the Administration's 5-year forecast. For these reasons, we and the Joint Committee have concluded that point estimates for periods beyond the budget window generally will not be provided.

The Honorable James Sasser
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The Office of Tax Analysis does project, however, that the revenue trend of the President's proposal would be positive after the budget period and that it would, if enacted, raise revenue modestly in all years after 1995.

Finally, you asked about the revenue cost of extending the President's capital gains proposal to corporations. The third enclosure (labeled Exhibit 3) indicates that such a proposal would cost $6.7 billion for FY 1990-95.

Sincerely,

Bryce L. Harlow
Assistant Secretary
(Legislative Affairs)

Exhibit 1

SENATOR SASSER'S QUESTIONS ABOUT TAX PROPOSALS DIRECTED AT CHURNING AND THE SHORT TERM OUTLOOK OF AMERICAN MANAGERS

Dole-Kassebaum Proposal

Under the proposal by Senators Dole and Kassebaum, pension funds would pay a 5 percent tax on capital gains from sales of assets held under 90 days, and a tax of 10 percent for assets held under 30 days. The proposal would not allow the subtraction of short term losses but would exclude short term gains which result from hedging transactions designed to reduce risk.

This proposal would discourage possibly misguided and costly attempts by pension portfolio managers to earn excessive investment returns by turning over their assets frequently. There is, in fact, little evidence that such high-turnover investment strategy has systematically succeeded. A 1986 study by the U.S. Department of Labor suggests that pension funds with high turnover rates have actually performed relatively poorly ("Study of the Investment Performance of ERISA Plans"). If such frequent turnover merely increases the variability of stock prices, less turnover would improve the quality of stock prices as a mechanism for providing market signals about the values of real corporate investments.

However, this proposal has the drawback of potentially raising the cost of capital for U.S. businesses as well as having a potentially negative effect on the investment markets. There are other ways beyond imposing a tax to encourage long term thinking on the part of investors and managers. The Treasury is completing a comprehensive review of possible measures to lower our cost of capital and improve the competitiveness of our business.

Other drawbacks of this proposal include: First, the tax would be imposed on gains without allowing deductions for losses, thus imposing a tax even when funds experience net short term losses. Second, the exclusion of qualified hedging transactions might create a tax avoidance mechanism. Under such an exclusion, hedging transactions could be constructed by investors in order to hold assets beyond the 30-day and 90-day deadlines without incurring extra risk. Unfortunately, it would be difficult to distinguish such transactions from hedging transactions which are simply designed to avoid short term risk. Third, short term transactions are not necessarily economically undesirable. Some short term investments are made while pension portfolio managers are searching for high quality long term investments after either receiving new pension contributions or selling stocks which have performed poorly. Some short term gains are generated by the controversial "index arbitrage" transactions, in which investors seek to profit from small unexpected differences between the spot market and futures market prices of stocks. It is not currently known whether such trades are good or bad for capital market efficiency. By taxing (and therefore possibly discouraging) such transactions, some investment efficiency and market liquidity could be lost.

Extension of the Short-Short Test

The second proposal would extend the "short-short" test to tax exempt pension funds. Under section 851(b)(3) of the Internal Revenue Code, a regulated investment company, such as a mutual fund, may derive no more than 30 percent of its gross income for any taxable year from the sale of securities held for less than three months. This is sometimes called the "short-short" test.

Extension of this test to pension funds, depending on details of the proposal and the sanctions that would be imposed by failure of the test, could have merit relative to the Dole-Kassebaum proposal. The 30 percent limit is probably high enough to permit funds to earn short term gains which are generated in the ordinary course of business without paying tax.

Like the Dole-Kassebaum proposal, however, this proposal has potential drawbacks. Because the test is applied to gross income before investment losses, a fund could fail the test and thus be subject to potentially severe sanctions even it is not deliberately "churning" its assets. For example, in the event of a stock market crash like that of October 1987, a hedging transaction designed to insure against such events could result in large offsetting gains and losses. Because the short-short test does not count losses, the large offsetting gains could cause a test failure if the asset sales fall under the three month limit. By penalizing funds for using futures and options markets to insure against stock market risk, the short-short rule would discourage such investment strategies. This would limit the ability of pension fund investors to follow reasonable low risk investment strategies, and thus possibly lower the liquidity and efficiency of financial options and futures markets.

TABLE 2

REVENUE EFFECTS OF THE PRESIDENT'S CAPITAL GAINS PROPOSAL

	Item 1/		Fiscal Year ($ Billions)						
			1990	1991	1992	1993	1994	1995	1990–95
I.	Loss on Existing Gains Under Plan	2/	–2.1	–14.1	–14.4	–13.9	–14.7	–15.5	–74.7
II.	Effect of Taxpayer Behavior	2/	2.8	19.0	16.2	13.3	14.0	14.3	79.6
	a. Induced Realization Effect		2.8	19.1	16.7	14.2	15.5	16.3	84.6
	b. Conversion of Ordinary Income		0.0	–0.1	–0.5	–0.9	–1.5	–2.0	–5.0
III.	Depreciation Recapture		–0.0	–0.3	0.5	1.1	1.6	1.7	4.6
IV.	AMT Expansion		–0.0	–0.2	0.5	0.6	0.8	0.8	2.5
V.	Effective Date Effect		–0.2	0.4	0.0	0.0	0.0	0.0	0.2
VI.	Total Effect of Proposal		0.5	4.9	2.8	1.2	1.7	1.4	12.5

Department of the Treasury
Office of Tax Analysis

February 28, 1990

1/ Lines I through IV assume January 1, 1990 effective date. Line V shows the effect of an effective date of March 15, 1990. All estimates ignore effects on economy. Details may not add to totals due to rounding.

2/ Estimates for a flat 30% exclusion are:

IA.	Loss on Existing Gains Under 30% Exclsion	-2.1	-14.3	-15.6	-16.6	-17.5	-18.4	-84.5
IIA.	Effect of Taxpayer Behavior Under 30% Exclsuion	2.8	19.3	18.4	17.0	16.6	17.0	91.1
	Induced Realization Effect	2.8	19.4	19.0	18.1	18.3	19.3	96.9
	Conversion of Ordinary Income	0.0	-0.1	-0.6	-1.1	-1.7	-2.3	-5.8
	Net Effect of Phase-in (I+II-IA-IIA)	0.0	-0.1	-1.0	-1.0	0.2	0.2	-1.7

EXHIBIT 3

THE PRESIDENT'S CAPITAL GAINS PROPOSAL APPLIED TO CORPORATIONS

Fiscal Years
($ Billions)

1990	1991	1992	1993	1994	1995	1990-95
0.1	-0.4	-1.1	-1.5	-1.8	-2.0	-6.7

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 23, 1990

The Honorable Frank R. Lautenberg
United States Senate
Washington, DC 20510

Dear Senator Lautenberg:

Secretary Brady has asked me to respond to the questions which you raised with respect to his testimony before the Senate Budget Committee on February 1, 1990. Each of your questions is addressed in the enclosed exhibits.

Exhibit 1 addresses your concern about the progressivity of the current tax system. As this exhibit notes, the current Federal tax system is quite progressive, despite recent headlines to the contrary. Exhibit 2 further notes that the total tax burden of middle-income Americans has not changed appreciably over the last decade.

Your third question, regarding the rationale for extending the Administration's proposed capital gains tax cut to currently held assets, is addressed in Exhibit 3. Not noted in that exhibit is the fact that, were existing assets to be excluded from the proposal, rather than having a positive revenue impact, over the budget period a revenue loss would result.

Exhibit 4 examines the the long-term revenue cost of the Family Savings Account proposal. As in the case of the capital gains proposal, expected macroeconomic feedback effects are not included in the revenue estimates. Even if these proposals were to result in only a very modest increase in future savings and investment, the feedback effect would make both proposals revenue producers.

I trust you will find this information helpful.

Sincerely,

B Harlow

Bryce L. Harlow
Assistant Secretary
(Legislative Affairs)

Enclosures

Exhibit 1

Progressivity of the Tax System

The Federal tax system is very progressive. All recent studies agree on this point. Data from 1987 individual tax returns show that the share of Federal income taxes paid by higher-income taxpayers has increased since 1981, while the share of income taxes paid by lower-income taxpayers decreased. The share paid by the top 5 percent of taxpayers increased from 35.4 percent to 43.2 percent, while the share of income taxes paid by the bottom 50 percent declined from 7.4 percent to 6.1 percent.

Progressivity is also apparent when the total Federal tax system is examined. For example, the recent analysis prepared by the Council of Economic Advisers and Office of Management and Budget ("Progressivity: An Analysis of the Ways and Means Study") estimates that the net impact of the tax and transfer system in 1987 increases the income of families in the lowest family income quintile by 3.7 percent, and decreases by 6.6 percent the income of families in the highest family income quintile.

Tax rates for taxpayers in the highest income level were higher in 1980 than today, but the 1980 economy, with its 12.5 percent inflation and 7 percent unemployment rate is not one to which many Americans would like to return. Current tax laws, which place greater emphasis on marginal incentives to work and save, raise a greater fraction of revenues from high income taxpayers than the seemingly more progressive tax system of 1980. The current distribution of the tax burden has proven itself compatible with national prosperity. We should not experiment with a more redistributive tax law which might endanger that success.

Exhibit 2

Tax Burden of Middle Income Taxpayers

As a percentage of family income, the burden of Federal taxes (including social security taxes) on middle income taxpayers has remained almost constant over the last decade. A recent analysis prepared by the Council of Economic Advisers and Office of Management and Budget ("Progressivity: An Analysis of the Ways and Means Study") shows that the share of taxes paid by middle income Americans has declined from 13.4 percent in 1980 to an estimated 12.6 percent in 1990.

Exhibit 3

Why is the Administration's Proposal Retroactive?

There are several reasons why the Administration's capital gains proposal provides an exclusion for all assets, and not just those acquired after the effective date of the proposal. First, the Tax Reform Act of 1986 retroactively raised tax rates on all accrued capital gains; simple fairness requires us to reduce capital gains taxes retroactively as well. Investors may be wary of making new investments if they feel that from time-to-time Congress might again change the rules, but in only one direction. Second, by granting the exclusion to all assets, the "unlocked" funds can be invested in new businesses, machinery, and products. This will allow capital to flow to where it will be utilized more efficiently, rather than being "locked in" to an investment.

Exhibit 4

Long-Term Revenue Loss of Family Savings Account Proposal

The General Explanations of the President's proposals, prepared by the Treasury Department, provides estimates of the cost of the FSA proposal for fiscal years 1990-1995. The estimates are as follows:

Fiscal Year					
1990	1991	1992	1993	1994	1995
(billions of dollars)					
*	-.2	-.6	-1.0	-1.3	-1.6

* Loss of less than $50 million.

These estimates were produced using the Administration's economic forecast, which is available only through 1995. To produce estimates for years beyond 1995 would require an extrapolation of the official forecast. Such an extrapolation would be highly problematic given the uncertainties surrounding long-run macroeconomic forecasts. Further, because savings behavior depends on demographic as well as macroeconomic factors, forecasts of demographic changes and of taxpayers' savings responses to these changes would also be required. Very small changes in the economic of demographic forecasts, or in estimates of taxpayers' behavioral responses, could lead to very large differences in long-run estimates of the cost of FSAs. Therefore, such long-run estimates would not provide a reliable guide for decision making.

Although we do not have a quantitative estimate of the long-run revenue cost of the FSA proposal, we can make some qualitative observations regarding the long-run cost of the proposal. Ignoring any "feedback" effects, the proposal is expected to continue to lose revenue beyond the budget period. The level of revenue loss will depend on the source of the FSA contributions and on the average length of time taxpayers hold FSAs.

In fact, however, the proposal is expected to lead to a modest increase in total savings. Even a small increase in savings can have a significant impact on GNP, and hence on total tax collections. Taking this "feedback" effect into account, the Council of Economic Advisors has estimated the proposal to be essentially revenue-neutral over the 1990-1995 period, and expects it to actually raise revenues thereafter.

WRITTEN QUESTIONS FROM SENATOR SASSER TO SECRETARY BRADY AND THE RESPONSES

Question 1. Does the delay we have experienced so far mean that the cost of the bailout will be more than the $166 billion it's now projected to cost over the next 10 years?

Answer. The Oversight Board believes that the RTC's pace of resolution to date has been creditable in view of the startup nature of the operation, the need to develop and implement new policies, and the Board's desire to involve the maximum number of potential bidders. We expect that with appropriate policies and procedures in place, the pace of resolution will pick up and that resolutions will proceed in an orderly fashion.

The $166 billion figure you quote is the estimate, widely reported in the press, of the RTC's gross cash outflows over the next ten years. In fact, it is an incorrect estimate; OMB projected the cash outflows to be $159 billion. Putting that aside, rather than working with the gross or net ten year cash flow estimates, Treasury has focused on the funds provided to pay for current and future thrift losses.

With regard to the estimated cost of resolving thrifts currently expected to fail, as we have said in the past, we do not yet know whether the $50 billion provided to the RTC will be sufficient. It depends on many variables, including the pattern of interest rates, the performance of local real estate markets, the general condition of regional economies, and the speed and efficiency with which thrifts are resolved and assets sold. If current losses do increase beyond the $50 billion, it may be necessary to reallocate the $32 billion provided in FIRREA to the Savings Association Insurance Fund (SAIF) to cover future thrift losses.

Question 2. Last week, FDIC Chairman Seidman indicated that the bailout will run out of money in mid-1991, and that Congress will need to make more money available. He said there could be an additional $24 billion needed to resolve 225 to 300 institutions that are now expected to slide into insolvency. What's your view? Is Seidman wrong?

Answer. Mr. Seidman testified that the losses in the institutions that the RTC must resolve may exceed $50 billion but that the RTC could not presently project the size of the losses from future failures because the cost will be determined by the condition of the institutions and market factors at the time of resolution. He said that the need for additional funding can be addressed with much greater certainty if, and when, the $50 billion proves to be inadequate. Moreover, FIRREA provided for the possibility of additional insolvencies among marginal thrifts with a maximum of $32 billion to cover thrift losses beginning in 1992.

In sum, it is very difficult to estimate accurately the number of institutions that will fail and the cost of the failures. The Oversight Board considers the important issue to be whether the RTC has adequate resources to begin resolving institutions now in conservatorship. We believe the answer is clearly yes, now that a working capital mechanism is in place. In other words, the Oversight Board and the RTC would at this time do nothing differently if the cost to the RTC were projected to be larger—they would focus on closing insolvent institutions.

Question 3. Lastly, one of the key assumptions used in costing the bailout was that deposits of the still solvent thrifts would grow at a rate of seven percent per year. Now it's pretty apparent that the declines in deposits that we've seen over the past two years will continue indefinitely, particularly as thrifts struggle to meet new rigorous capital standards that, in turn, will reduce the industry's contribution to the bailout. Will the taxpayers be picking up an even greater share of the cost because premium income will be down?

Answer. There has been considerable confussion about the relevance of the growth rate for deposits insured by the SAIF fund. Changes in the size of the SAIF assessment base do not increase the size of the thrift losses for the RTC; that is, the size of the assessment base does not change the estimated $50 billion needed by the RTC to resolve thrifts that have failed or will fail from January 1, 1989 through August 9, 1992, nor does it lessen in anyway the amount of fund available nor the industry's contribution to RTC's funding.

Furthermore, the seven percent number has not been used since the budget submission in January 1989. It was reduced to five percent in last July's budget re-estimate and was reduced again in the fiscal 1991 budget projection to show no growth for these deposits.

What the growth rate does affect is the amount of premium income that will be received by SAIF in the out years, which counts as a budget receipt. This is offset to some extent by increases in bank assessments on deposits which are shifted from thrifts to banks. These receipts reduce the size of the annual budget deficit. In addition, a decline in receipts is likely to increase the amount that the Treasury is required to pay to capitalize SAIF, since the statute requires that SAIF receive a minimum of $2 billion annually from 1992 to 1999 from a combination of premiums and appropriated funds. Any out year increase in taxpayer funds should not be significant in relation to the overall cost estimates.

Question 4. Are we on the brink of a major problem with the solvency of our banks and their insurance fund? Is there anything we can do to strengthen the bank insurance fund to avert another huge budget hit like the one for the S&Ls?

Answer. We do not appear to be on the brink of a major problem with the solvency of our banks or the bank insurance fund. As a whole, the banking industry is healthy and stong. Although problems do exist, they tend to be scattered and generally affect smaller institutions—the banking industry is not facing the kind of widespread failure rate that has rocked the S&L industry over the past several years. In fact, the number of banks on the list of problem banks peaked a few years ago and and has declined by nearly a third since that time.

Nevertheless, your concern is well placed. No one wants another deposit incurance fund to become insolvent. In fact, the Administration proposed, and FIRREA contains, provisions requiring both the bank and savings association insurance funds to increase their reserve-to-deposit ratios to 1.25 percent. As the preface to your questions mentioned, that ratio is now 0.8 percent, the lowest in FDIC history. However, FDIC proejctions suggest that the FIRREA-mandated increases in the insurance premiums paid by banks from 0.833 percent to 0.15 percent, an 80 percent increase, will result in net revenues of about $1 to $2 billion per year over the next ten years, which will help to bolster the fund size.

The data suggest to me that we keep a close eye on the banking industry and its insurance fund, in light of the real estate situation in the northeast and elsewhere, the status of leveraged buyouts, and the value of LDC loans. However, the industry and its fund appear to be in a position to handle foreseeable problems. Moreover, Treasury's study of the federal deposit insurance system will likely propose ways in which the bank and savings association insurance funds can be better protected.

Question 5. Should we consider limiting the scope of deposit insurance so as to cut back on the exposure of the taxpayers?

Answer. The scope of deposit insurance is an important issue in that it directly affects the safety and soundness of the deposit insurance funds and the overall exposure of the nation's taxpayers. Therefore, it most certainly should be considered by anyone examining federal deposit insurance in a serious manner.

However, I do not believe that this is the appropriate time for me to express any substantive veiws on the subject. As you know, the Treasury Department is currently conducting a comprehensive study of the sytem of federal deposit insurance, pursuant to the legislative mandate of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Consequently, to comment at this time would be to prejudge the outcome of our study, which must be submitted to Congress by February 9, 1991.

I believe our final report will shed light on this and numerous other issues affecting our federal deposit insurance system. Our project is already underway, in full consultation with the participating regualtory and administrative agencies.

Question 6. What about these new instruments, like BICs and UITs, where deposit insurance is "passed-through" to shareholders? Is this an over-extension of the FDIC's liability?

Answer. Pass-through instruments also raise concerns about the safety and soundness of the deposit insurance funds and the exposure of the taxpayers. As with the scope of federal deposit insurance, however, these instruments are included in the Treasury study of the federal deposit insurance system, which makes it premature for me to provide any substantive views on the subject at this time.

CORPORATE DEBT COMPETITIVENESS

Question 7. What about this? I'd like to hear your comments on debt levels generally and its effect on our competitiveness, on research and development, and on the solvency of our banking system.

Answer. Corporate debt levels rose considerably during the decade of the 1980s, however, several factors need to be considered to put this in perspective. The market value of stocks also rose during this period at approximately the same rate. Thus, leverage, when measured on a market value basis, has not increased substantially at all. Secondly, the leverage of American companies remains today at a level below that in the U.K. and considerably lower than in West Germany and Japan.

I do believe that, in recent years, selected companies became over-leveraged. But, I do not believe that the shakeout of poorly structured LBOs will have a significant impact on our economy. We reviewed carefully the impact to date of leveraged buyouts on research and development as well as on the banking system.

If you look at the companies which have undergone LBOs, you will find very few of them are in research intensive industries; in fact most LBO companies reported no expenditures on research and development the year prior to the transaction. The Campeau's Safeway's and RJR's of the world do not spend a lot of money on research.

The banking regulators have assessed the current situation at our nation's banks and have taken steps to assure that LBO lending is properly monitored and reported. The OCC recently issued new guidelines for banks to report "highly leveraged transactions." The regulators are reviewing credit and internal control procedures at major banks and have expressed to us that LBO debt is under control at our nation's top banks. In fact, a significant percentage of total LBO exposure has been sold off to foreign banks during recent years.

In general, the effect of LBOs on competitiveness is difficult to measure. There has been a lot of discussion about companies whose strategies or operations have been pared back due to large interest payments. There is much less talk about the companies which were streamlined, restructured or sold to owners who would focus more attention on them and how this phenomenon has made many businesses leaner and more focused. Some studies completed to date actually indicate that companies, on average, perform better after an LBO. In my opinion, it would be inappropriate to conclude that LBOs have a deleterious impact on competitiveness because of a few highly publicized failures.

WRITTEN QUESTIONS FROM SENATOR CONRAD TO SECRETARY BRADY AND THE RESPONSES

Question 1. On January 2, the Wall Street Journal carried a front-page story describing a serious deterioration in the enforcement capability of the IRS. The problems cited in this article (thoroughly outmoded computer systems, soaring turnover rates, hiring freezes which prevent the filling of vacancies, declines in the skill levels of new recruits) are preventing the agency from pursuing promising cases and are costing the Treasury enormous amounts of money.

The story contained this quote from IRS Commissioner Fred Goldberg: "If we had more people and better trained people we'd raise a lot more money." Responding to the question of how much, he is quoted as saying: "You need 40 billion? You got it."

With this year's deficit target of $64 billion, we should be doing everything we can to strengthen Federal tax compliance and collect the billions that are owed and due—but are currently not paid-under existing law. Is your administration committed to making a substantial, multi-year investment that would produce the improvements in compliance that the IRS Commissioner is referring to in his statement to the Wall Street Journal?

Answer. The 1991 budget contains the first year of a long-term investment that includes high priority management and budget initiatives designed to improve compliance and collect, in FY 1991, $3 billion in additional revenue owed the government. These initiatives will provide over $9 billion in additional tax revenues through FY 1995.

Of the additional $3 billion that will be generated in FY 1991, $2.5 billion results from management initiatives which require no new resources from the Congress. Existing staff will be redeployed to accelerate the closing of disputed large dollar audit cases, reduce tax shelter case inventory backlog, and increase audit coverage of certain excise tax and pension plan issues.

The budget also provides $191 million in funding for compliance initiatives to expand collection and examination activities. The first year of this investment will bring in $537 million that might otherwise have gone uncollected.

Question 2 (Part I). The fiscal 1991 budget request for the IRS seeks an increase of $635 million as compared with fiscal year 1990. Of this, $259 million is intended for enforcement, to permit the hiring of 2,400 additional auditors and 1,050 additional collection agents.

After two years of significant retrenchment at the IRS, these are welcome increases. But haven't both of these categories of positions been severely affected by hiring freezes and turnover of experienced personnel in recent years? How much of the increases sought will be absorbed filling vacancies created by these freezes, as opposed to enabling new initiatives? Is it true that the IRS could use $500 million just to fill existing vacancies in examinations and in the legal department?

Answer. Due to sequestration and absorption of the January 1990 pay increase, IRS had to delay implementation of initiatives included in the Bi-Partisan Budget Agreement, primarily through the continuation of the 1989 hiring freeze. This has resulted in revenue losses totalling $350 million compared to those included in the original agreement.

IRS has lifted the freeze for some selected enforcement areas and is considering other actions as part of the current financial review. The goal is to hire as many direct enforcement personnel as possible in order to ensure full support for the Bi-Partisan Agreement in 1991.

Funding for the FY 1991 Budget assumes the following: Funding necessary to cover the full Bi-Partisan Agreement approved in the fiscal year 1990 Appropriation, additional resources (nearly 3,500 positions) to support a major compliance initiative beyond levels included in the 1990 Bi-Partisan Budget Agreement.

Question 2 (Part II). What would it take (in terms of additional positions, over a period of years) to return audit coverage to the levels of the mid-1970s?

Answer. In FY 1975, the audit coverage rate was 2.50%. In this budget request, we estimate that audit coverage will be 1.03% in fiscal year 1991. This decline can be attributed to many external factors: The major tax law changes in the last fifteen years, including the Tax Equity and Fiscal Responsibility Act 1982; the increasing complexity of tax returns filed; and the influx of abusive tax shelters.

Over the past 15 years, the tools available to IRS for addressing incorrect self-assessments by taxpayers have been substantially augmented. The expanded use of ADP and document matching technology has greatly facilitated the identification of specific discrepancies on returns. Millions of taxpayers are now contacted each year to resolve these discrepancies and tax adjustments are made as a result. Several years ago, these issues would have been worked as they occurred as part of cases in district offices. These cases, largely in the office examination program, contributed to examination coverage. Now, these single issue adjustments are worked by correspondence from service centers and are not incorporated in examination coverage computations.

In the future we anticipate our capability for isolating specific taxpayer errors on returns without conducting a full review of books and records will increase even more dramatically. Because of changes in the way we do our work, "audit coverage" needs to be redefined if it is to serve as a useful performance indicator and we are in the process of doing so.

Question 2 (Part III). What would it take to achieve a 25 percent reduction in accounts receivable, which currently exceed $60 billion? Could the IRS readily collect $10 billion to $15 billion of delinquent accounts if it had more collection agents, by concentrating on cases in which returns were filed but the taxes weren't paid, or in which employers failed to pay taxes that were withheld from their employees?

Answer. Although a long-term investment in Collection resources will help curtail the growth of accounts receivable, there are other facets to the problem that must be addressed, which complicate any direct answer to the question.

In 1986, the IRS began a number of major efforts to better manage accounts receivable, and has continued these efforts to the present. A quality improvement team proposed 40 systemic changes to provide better information and to correct conditions that were preventing proper applications of payments. They also identified 12 program areas with additional potential for reducing the dollar inventory or improving management oversight. Other efforts concentrated on cleaning out major problem cases and categorizing problem areas. As a result, we have targeted four vital issue areas that are expected to address a large portion of the accounts receivable problems. These areas are:

1. LARGE DOLLAR ACCOUNTS.—Identify large accounts for special attention in order to determine what problems are keeping these accounts in inventory. Develop national procedures. Develop management information systems to facilitate analysis and tracking large accounts and for monitoring trends.
2. CURRENTLY NOT COLLECTIBLE ACCOUNTS.—Review entire collection process to determine why this category is growing at a faster rate than other categories. Develop procedures for monitoring these accounts.
3. SYSTEMIC PROCESSING AND PROCEDURAL PROBLEMS INVOLVING CASES IN BANKRUPTCY, LITIGATION, OR UNDER CURRENT INSTALLMENT AGREEMENTS.—Test the centralization of notice review processing, large dollar notices, and other processes to give more focus to correcting systemic and procedural problems.
4. ACCOUNTS RECEIVABLE MANAGEMENT INFORMATION SYSTEM AND CONTROLS.—Implement a new management information system. Identify trends, improve reports, analysis, and oversight. Develop a three-stage process for a new Financial Management System.

We are also improving our accounting and management information systems in order to bring them more in line with accepted private sector accounting practices. This is a long-term effort that will not be completed for many years. Nevertheless, it is already beginning to improve our management information.

In addition to the improvements already underway, we believe that any long-term strategy for collecting accounts receivable will be effective to the extent we can:

1. SIMPLY THE RULES AND PROCEDURES.—A substantial amount of the dollars in inventory are there because taxpayers either did not know the rules or know how to comply. When the law is too complex, both the IRS and taxpayers make mistakes. Often these mistakes cannot be corrected until the account is in active collection status. This result is costly and burdensome for both the IRS and the taxpayers.

2. MODERNIZE OUR TAX SYSTEM.—Implementation of IRS' Tax System Modernization will reduce errors at the initial stages of processing so that fewer erroneous assessments will be made. It will also provide faster access and more accurate information on taxpayer accounts. Finally, a modernized computer system will provide better information for both accounting and management use.

3. PROVIDE CONSISTENT FUNDING.—The President's fiscal year 1991 budget request includes a substantial increase for collection activities. This increase will provide funding for staff to handle additional correspondence and collection activities that necessarily increase when the number of taxpayers increases, the average dollar assessed increases, and compliance activities increases. The FY 1991 Collection initiative B the maximum amount of resources that we can prudently absorb and train in one year. Further investments to increase IRS collection capabilities could be added to future budgets, but again, only in a framework of systematic, measured increments that would not disrupt existing productivity.

Question 3. Are any of these (targeted Appeals) cases in court at the moment, and do you expect all of the cases to be resolved within the fiscal year?

Answer. The 47 cases mentioned were identified as the result of a preliminary review conducted at the national level in Appeals. A more thorough review is now being conducted at the local level which will allow us to better assess which cases will actually close by the end of FY 91. However, the thrust of the initiative is the better management of all large cases, with additional resources applied as needed, to help the cases move more quickly. The procedural changes encompassed by the management initiative will guarantee the overall success of the initiative whether or not the 47 cases preliminarily identified are the cases that actually close. The idea is to make the whole system more efficient so that it produces the desired result without having to alter the fair and impartial settlement philosophy that has always been a part of Appeals.

Some of the identified cases were in docketed status and are therefore "before the court". However, all are in Appeals jurisdiction, which means settlement negotiations are being conducted rather than preparation for trial. Once the analysis at the local level is complete we will have a better idea which cases will close within the fiscal year. All cases of this size are quite complex and the negotiation process is difficult to predict. No settlement can be reached without the cooperation of the taxpayer, which means we are never able to predict with absolute certainty when or if a case will settle.

Question 4. Do the targed cases include any of the Saudi crude oil pricing cases?

Answer. Given the preliminary nature of the review that has been conducted to date and the sensitivity of the negotiations now ongoing, we feel it is inappropriate to identify any specific taxpayers. As indicated above, the success of the initiative is not dependent upon any particular case or group of cases. Instead, it is dependent upon Appeals' ability to organize their resources in the Large Case Program more effectively and focus on moving these few large cases more efficiently in FY 91 and in the future.

Question 5. Can we get a list of the 47 cases, their status, and their expected settlements?

Answer. Again, we feel that making that information known would jeopardize the settlement negotiations that are currently underway. The review conducted to date was only a preliminary one. However, even a more thorough review will be subject to change due to the uncerain nature of the negotiation process. If a taxpayer knows he is part of a plan to accelerate revenue he will be thinking in terms of how he can use the process to his advantage. He will be expecting "a better deal" or he will withhold his cooperation until the deadline for the initiative approaches, thinking he can use the deadline as leverage in his case. We want these cases to move through the system more efficiently, but we expect the settlements negotiated by our Appeals Officers to be as fair and impartial as they have always been.

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